Chapter 4: C Corporations

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Please note. Corrections were made to this workbook through January of 2019. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, cuts the corporate tax rate to 21%, which is 16 percentage points lower than the highest individual tax rate of 37%. On the surface, that seems to be a rather significant incentive to form a C corporation for conducting a business rather than a pass-through entity in which the business income flows through to the owners and is taxed at the individual income tax rates. In addition, a C corporation can deduct state and local taxes without the limitations that apply to owners of pass-through entities or sole proprietors.

Are these two features enough to clearly say that a C corporation is the entity of choice under the TCJA? In most client situations, the answer is likely "no."

TAX COMPARISONS

The fact that corporations are now subject to a flat tax rate of 21% is one of many factors that should be considered in determining whether a C corporation structure is appropriate. For instance, the TCJA continues the multiple tax bracket system for individual income taxation and also creates a new 20% deduction for pass-through income for the 2018 through 2025 tax years: the qualified business income deduction (QBID). In addition, for many smaller businesses, the flat 21% rate could actually result in an increase in tax liability. Many of these businesses purposely kept taxable income at or near $50,000 to take advantage of the former 15% rate.

The TCJA does not change or otherwise eliminate taxation on income distributed (or funds withdrawn) from a C corporation — the double-tax effect of C corporation distributions. These factors somewhat mute the apparent advantage of the lower corporate rate.

> **Note.** For more details about the new tax rates for individuals, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns. For more information about the QBID, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

As shown in the following table, under the new individual income tax rate structure, the top bracket is reached at $600,000 for a married taxpayer filing jointly (MFJ) for the 2018 tax year. For those filing as single taxpayers or as head of household (HoH), the top bracket is reached at $500,000.[1] Of course, not every business structured as a sole proprietorship or a pass-through entity generates taxable income in an amount that triggers the top rate. As shown in the following table, up to $77,400 of taxable income for MFJ taxpayers is taxed at rates lower than the 21% corporate rate. Therefore, businesses with relatively lower levels of income will likely be taxed at a lower rate if they are not structured as C corporations.

Taxable Income Brackets for Individuals — 2018

Tax Rate	Married Filing Jointly and Surviving Spouses	Head of Household	Single	Married Filing Separately
10%	$ 0–19,050	$ 0–13,600	$ 0–9,525	$ 0–9,525
12%	19,051–77,400	13,601–51,800	9,526–38,700	9,526–38,700
22%	77,401–165,000	51,801–82,500	38,701–82,500	38,701–82,500
24%	165,001–315,000	82,501–157,500	82,501–157,500	82,501–157,500
32%	315,001–400,000	157,501–200,000	157,501–200,000	157,501–200,000
35%	400,001–600,000	200,001–500,000	200,001–500,000	200,001–300,000
37%	Over 600,000	Over 500,000	Over 500,000	Over 300,000

1. IRC §1(j).

RATE COMPUTATION — FISCAL-YEAR CORPORATIONS

Under the TCJA, the tax computation for a calendar-year corporate tax return is fairly simple. For 2018 and future years, a flat rate of 21% is applied. However, for fiscal-year corporations with a fiscal year that begins in 2017 and ends in 2018, the tax computation is more complicated. The tax is calculated by determining the proportionate number of days in 2017 and applying the 2017 rate to that share of taxable income, then taking the proportionate number of days in 2018 and applying the 2018 rate to that share of taxable income.[2]

Example 1. Widget Corporation has a March 31, 2018 yearend. It earned exactly $50,000 of income. The number of days in its tax year before January 1, 2018, is 275, which is 75.34% of the total number of days in the tax year. The number of days after January 1, 2018, is 90, which is 24.66% of the total number of days in the tax year.

Tax on $50,000 in 2017 is $7,500 ($50,000 × 15%); therefore, the tax for 275 days is $5,651 ($7,500 × 75.34%). The tax on $50,000 in 2018 at 21% is $10,500. Therefore, the tax for 90 days is $2,589 ($10,500 × 24.66%). Thus, Widget Corporation will pay tax of $8,240 ($5,651 + $2,589) for the year ended March 31, 2018.

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Planning Tip. The blended rate drops by 1.17% per month ((35% – 21%) ÷ 12 months). Consequently, many fiscal-year corporations are in a higher tax bracket in 2017–2018 than they will be in future years. Thus, corporate-level deductions may be worth more in fiscal year 2017–2018 than they will be in future years. Corporations can realize a tax benefit by utilizing tax strategies that accelerate deductions when the applicable tax rate is higher and defer income to tax years when the applicable rate is lower.

In Notice 2018-38,[3] the IRS confirmed that in determining the tax on corporate income under IRC §11(a), IRC §15 applies to fiscal-year corporations when the corporation's tax year began before January 1, 2018, and ends after December 31, 2017, resulting in a blended tax rate as explained above. The IRS also noted that certain fiscal-year corporations (e.g., life insurance companies and regulated investment companies) that compute tax liability under IRC §11(b) must also compute tax liability for a tax year straddling January 1, 2018, in accordance with the IRC §15 formula. The IRS also pointed out that the repeal of the corporate alternative minimum tax (AMT) under the TCJA is a change in the tentative minimum tax rate from 20% to zero under IRC §§15(a) and (b), with a January 1, 2018, effective date.[4]

PASS-THROUGH DEDUCTION

As mentioned earlier, under the TCJA, for tax years beginning after 2017 and before 2026, an individual business owner as well as an owner of an interest in a pass-through entity is generally entitled to a QBID of 20% of the individual's share of business taxable income.[5] However, for taxpayers who exceed a taxable income threshold ($315,000 for MFJ taxpayers and $157,500 for all other taxpayers), the deduction is limited to the lesser of:

- 20% of QBI, or
- The **greater** of:
  - 50% of the W-2 wages paid with respect to the qualified trade or business, or
  - 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property (QP).[6]

2. IRC §15.

3. IRS Notice 2018-38, 2018-18 IRB 522.

4. Under IRC §15(a), a fiscal-year corporation's tentative minimum tax is computed by applying the corporate AMT rate for 2017 through December 31, 2017, with a tentative minimum tax computed by applying the 0% rate through the balance of the fiscal year. The corporation's tentative minimum tax for the tax year that includes January 1, 2018, is the sum of that proportion of each tentative minimum tax which the number of days in each period bears to the number of days in the entire tax year.

5. IRC §199A.

6. IRC §199A(b)(2).

This limitation is phased in for MFJ taxpayers with taxable income between $315,000 and $415,000. For all other taxpayers, the limitation is phased in for taxable income between $157,500 and $207,500.

Architects and engineers can claim the QBID, but other service business are limited in their ability to claim it.[7] For them, the QBID is phased out when taxable income exceeds $315,000 for MFJ taxpayers and $157,500 for all others.

The QBID results in tax savings on qualifying income, but the extent of the savings depends on the percentage of income that a business generates that qualifies for the deduction and the taxpayer's marginal tax bracket. If pass-through income is taxed at the highest rate of 37%, the QBID reduces the 37% rate to effectively 29.6%. However, as the normal rate applicable to the income of a pass-through (or sole proprietor) business decreases, the benefit of the QBID also decreases. Only when individual marginal income tax rates are 24% or less does the QBID reduce the effective rate beneath the 21% corporate rate (assuming all pass-through income is qualifying income). The more nonqualifying income a sole proprietor (or pass-through business) has, the less the effect the QBID has in lowering the effective average marginal income tax rate.

The TCJA provides a windfall for personal service corporations (PSCs). They were taxed, under prior law, at a flat 35%.[8] Under the TCJA, they are subject to the same 21% flat rate applicable to other C corporations.

Observation. Clearly, the amount of income a business generates and the type of business impacts the choice of entity. For further elaboration of this point, see the discussion of the QBID and the impact of W-2 wages and QP basis in the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. For more information on comparison of entities, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Entity Comparison.

ADDITIONAL TAX ON DISTRIBUTED INCOME

Another factor influencing the choice between a C corporation or a flow-through entity is whether the C corporation distributes income, either as a dividend or when shares of stock are sold. The TCJA, in general, does not change the tax rules concerning qualified dividends and long-term capital gains. Preferential tax rates apply at either a 15% or 20% rate, with an additional 3.8% net investment income tax that applies in certain situations.[9] If the corporate "double tax" applies, the pass-through effective rate is always lower than the combined rates applied to the corporation and its shareholders. This is true even without factoring in the 20% QBID for pass-through entities.

However, for certain pass-through service businesses that have higher levels of income that are subject to the QBID limits, the effective tax rate is almost the same as the rate that applies to a corporation that distributes income to its shareholders. This is particularly true because a corporation can deduct state taxes for any of the 44 states[10] that impose a corporate tax and because PSCs are now taxed at the same 21% rate as all C corporations (rather than the flat 35% that previously applied).[11]

Observation. The 21% corporate tax applies to nondeductible dividend distributions. An individual taxpayer's tax on the dividend can range from 15% to 23.8%. The combined result almost always exceeds the individual rate applicable to income from a pass-through entity.

7. IRC §199A(d)(2).

8. A personal service corporation is one in which the employee-owners perform at least 20% of the personal services and own at least 10% of the outstanding stock of the corporation on the last day of an initial 1-year testing period. See IRS Pub. 542, *Corporations.*

9. IRC §1411.

10. See, e.g., *State Corporate Income Tax Rates and Brackets for 2018.* Scarboro, Morgan. Feb. 7, 2018. Tax Foundation. [taxfoundation.org/state-corporate-income-tax-rates-brackets-2018/] Accessed on Jun. 20, 2018.

11. IRC §11(b).

OTHER CONSIDERATIONS

ACCUMULATED EARNINGS TAX

C corporations that have taxable income are also potentially subject to penalty taxes. There is substantial motivation for many corporations **not** to declare dividends because of their unfavorable tax treatment. Dividends are taxed twice, once when the income is earned by the corporation and again when corporate earnings are distributed as dividends to the shareholders. This provides a disincentive for corporations to make dividend distributions. Consequently, this often leads to a build-up of earnings and profits (E&P) within the corporation.

The accumulated earnings tax (AET) is a 20% tax in addition to a corporation's regular income tax.[12] The AET is designed to prevent a corporation from being used to shield its shareholders from the individual income tax through accumulation of E&P instead of the income being distributed as dividends.[13] It applies to "accumulated taxable income" of the corporation (taxable income, with certain adjustments).[14]

Note. The AET is a pure "penalty" tax. The 20% tax is **in addition** to whatever tax already applies to the corporation. For instance, it is added to the corporate tax rate of 21% under the TCJA, for a combined rate of 41%.

The 20% AET applies only to amounts **unreasonably** accumulated during the tax year. Indeed, the computation of "accumulated taxable income" is a function of the reasonable needs of the business.[15] Consequently, the real issue is the extent to which corporate E&P can accumulate before triggering application of the AET. To that end, the Code provides for a credit, which specifies that corporations are generally permitted to accumulate E&P of $250,000 without imposition of the tax.[16] However, service corporations (fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting) can only accumulate E&P of $150,000.[17]

As mentioned earlier, not every corporation that exceeds $250,000 (or $150,000) of accumulated E&P is subject to the AET. This is because the tax applies only if a particular corporation has accumulated more than $250,000 (or $150,000) in E&P **and** the accumulation is beyond the reasonable needs of the business.

Observation. If a corporation's accumulated E&P exceed $250,000 (or $150,000 for service businesses), annual minutes for the corporation should specify the various corporate business purposes for which earnings are being retained and not paid out as dividends. A corporation may retain E&P for repayment of debt (non-shareholder loans), expansion of the business, working capital needs, etc.).[18]

Note. An underpayment of the AET may be subject to negligence penalties.[19] Interest is imposed on an AET underpayment from the due date of the corporation's tax return, determined without regard to extensions.[20]

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12. IRC §531.
13. IRC §532.
14. IRC §535.
15. IRC §535(c).
16. IRC §535(c)(2)(A).
17. IRC §535(c)(2)(B).
18. See, e.g., *Gustafson's Dairy v. Comm'r,* TC Memo 1997-519 (Nov. 17, 1997). Treas. Reg. §1.537-1(b)(1) states that the corporation must have specific, definite, and feasible plans for the use of accumulated E&P.
19. Rev. Rul. 75-330, 1975-2 CB 496.
20. IRC §6601(b).

PERSONAL HOLDING COMPANY TAX

The personal holding company (PHC) tax is another penalty tax applicable to C corporations.[21] The 20% PHC tax is levied on undistributed PHC income (taxable income less dividends actually paid, federal taxes paid, excess charitable contributions, and net capital gains).[22]

A corporation must meet two tests to be a PHC. The first test is an ownership test. This test is satisfied if five or fewer people own more than 50% of the corporate stock during the last half of the tax year.[23] Many small, closely held family corporations meet this test. The second test is an income test and is satisfied if 60% or more of the corporation's adjusted ordinary gross income (reduced by production costs) comes from passive investment sources.[24]

SALE OF BUSINESS

If the business will be sold, the tax impact of the sale should be considered. Whether a corporation or pass-through entity is better from a tax standpoint when the business is sold depends upon whether the sale will consist of the business equity or the business assets. If the sale involves equity (corporate stock), then the sale of the C or S corporate stock will likely be taxed at a preferential capital gain rate. Additionally, for a qualified small business (a specially defined term), if the stock was held for more than five years at the time it is sold, a portion of the gain (or in some cases, all of the gain) can be excluded from federal tax.[25] Any gain that does not qualify to be excluded from tax is taxed at a 28% rate (if the taxpayer is in the 15% or 20% bracket for regular long-term capital gains).[26]

If the sale of the business involves the corporate assets, then flow-through entities have an advantage. A C corporation is subject to "double" taxation. The corporation recognizes gain taxed at 21%, and then a second layer of tax applies to the net funds distributed to the shareholders. This compares unfavorably to the sale of a pass-through entity's assets, which are generally taxed at a single level at long-term capital gain rates.

C CORPORATION ADVANTAGES

The use of a C corporation entity structure may provide the owner with certain advantages, which include the following.

- A C corporation entity structure may provide the owner with more funds to invest in the business.
- A C corporation can be used to fund the owner's retirement plan in an efficient manner.
- Fringe benefits are generally more advantageous with a C corporation as compared to a pass-through entity (although the TCJA changes this to some degree).
- Under the TCJA, a C corporation is not subject to AMT.

21. IRC §§541–547.
22. IRC §541.
23. IRC §542(a)(2).
24. IRC §542(a)(1). See also, e.g., TAM 200022001 (Nov. 2, 1999).
25. IRC §1202.
26. IRC §1(h)(4). Also, instead of a sale, a corporation can be reorganized tax-free as discussed later in this chapter.

CONVERTING AN S CORPORATION TO A C CORPORATION

Regardless of other considerations, some taxpayers with existing S corporations may consider converting the S corporation to a C corporation. Some businesses may view the reduction of the corporate tax rate relative to tax rates applicable to pass-through business income (even though the 20% QBID might apply) as sufficient incentive to convert an S corporation to a C corporation. However, the decision to convert from an S corporation to a C corporation involves more than simply comparing applicable tax rates.

REVOCATION OF S ELECTION AND ALLOCATIONS

Upon the consent of a majority of the shareholders (those holding more than 50% of the S corporation stock), an S election can be revoked.[27] An S corporation election can be revoked at any time majority consent is given. Therefore, the effective date of the revocation can be selected. However, the filing of the revocation must occur by the 15th day of the third month of the tax year to be retroactively effective as of the beginning of the tax year.[28]

Alternatively, an S corporation can revoke its election at any time during the year if the effective date is on or after the date that the revocation is made.[29] In that event, two short-period returns are required for the year of the termination. An S corporation return must be completed for the period from the beginning of the tax year until the day immediately preceding the date of revocation, and a C corporate return must be filed that covers the balance of the tax year.[30] However, the corporation can allocate income pro rata or elect to allocate income according to its normal tax accounting method.[31]

> **Note.** The default proration method may be the easiest approach, but an evaluation should be made to determine if electing a different approach would yield a significant tax savings based on the particular facts and circumstances.

Although S corporation and C corporation returns must be filed for the two short periods, respectively, the Code states that the S corporation return is required to be filed by the same due date as the C corporation return (including extensions).[32] Thus, the unextended due date for an S corporation short-year return is generally **April 15** rather than March 15 (for a calendar-year corporation).

ACCOUNTING ISSUES

In the tax year that the S election is terminated as well as for all future C corporation years, many income and deduction items are treated differently for tax purposes than they were when the entity was an S corporation. This includes timing deductions for shareholder accruals and the timing rules applicable to an S corporation.[33] In addition, charitable deductions are handled differently for S corporations and C corporations, as are capital losses and fringe benefits. Likewise, an S corporation that utilizes cash accounting is generally required to use accrual accounting if it converts to a C corporation and average annual receipts exceed $25 million over three years.[34]

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27. IRC §1362(d)(1)(B). To re-elect S status in the future, unanimous consent is necessary. IRC §1362(a)(2).
28. IRC §1362(d)(1)(C)(i). A revocation filed after the 15th day of the third month of the tax year is effective on the first day of the next tax year. IRC §1362(d)(1)(C)(ii).
29. IRC §1362(d)(1)(D).
30. IRC §§1362(e)(1)(A) and (e)(2).
31. IRC §1362(e)(3). This requires the consent of all persons who were shareholders of the S corporation at any time during the short S corporation year in addition to anyone holding shares as of the first day of the C corporation short period. IRC §1362(e)(3)(B).
32. IRC §1362(e)(6)(B).
33. See, generally, IRC §267.
34. IRC §448.

For a midyear revocation of an S election, the S corporation short-year income is reported by its shareholders in the same tax year that it would have been without the revocation.[35]

Example 2. Saga, Inc., is an S corporation with a July 31 yearend. It terminates its S election as of December 31, 2018.

Saga's shareholders report the income for the S corporation short year from August 1, 2018, through December 31, 2018, on their respective 2019 Forms 1040 even though Saga's short tax year ended in 2018.

Observation. For S corporations that also have subsidiary S corporations (qualified subchapter S subsidiaries (QSUBs)), the termination of the S election results in the termination of the election for any QSUB.[36] Consequently, a former QSUB is then treated as a new corporation that has acquired its assets (and liabilities) from the former S corporation in exchange for stock of the new C corporation.[37]

POST-TERMINATION DISTRIBUTIONS

When an S corporation converts to a C corporation, a post-termination transition period (PTTP) exists as a grace period to allow the former S corporation to continue to use the S corporation rules of IRC §1371(e)(1) to make distributions.[38] The PTTP begins on the day after the S corporation is terminated and ends **one year** after the S corporation termination date or the due date for filing the final S corporate return (including extensions), whichever is later.[39]

During the PTTP, the former S corporation can distribute "money" tax-free to the shareholders to the extent of the corporation's accumulated adjustments account (AAA) and the shareholders' stock basis.[40] For this purpose, the courts have defined **money as cash or the equivalent of cash** (in lieu of a statutory definition).[41]

The AAA is an S corporation account that is adjusted over the PTTP for the same items described in IRC §1367 that affect the shareholder's basis, except that tax-exempt income (and related expenses) and certain federal tax liabilities do not affect the AAA.[42] In general, an S corporation without E&P does not need to maintain an AAA in order to determine the tax effect of distributions. In this case, the distributions are nontaxable to the extent of stock basis and are taxable as distributions once stock basis is exhausted.[43]

Observation. The grace period of the PTTP helps to prevent undistributed S corporation earnings that have already been taxed to the shareholders from being "locked in" the S corporation (and double-taxed to the C corporation's shareholders), provided that the corporation has or can borrow sufficient cash to distribute the AAA to its shareholders tax-free.

35. Treas. Reg. §1.1362-3(c)(6).

36. Treas. Reg. §1.1361-5(a)(1).

37. It is likely, however, that gain is not recognized on the exchange due to IRC §351 unless the liabilities of the former QSUB exceed the tax basis of the assets. See IRC §357.

38. IRC §1377(b)(1).

39. Ibid.

40. IRC §1368.

41. See, e.g., *Clark v. Comm'r,* 58 TC 94 (1972); *Fountain, et al. v. Comm'r,* 59 TC 696 (1973); *Roesel v. Comm'r,* 56 TC 14 (1971).

42. IRC §1368(e)(1)(A). The AAA is not apportioned among shareholders. When an S corporation begins, the AAA balance is zero. Treas. Reg. §1.1368-2(a)(1).

43. IRC §301(c)(3).

A key consideration of the decision about converting an S corporation to a C corporation involves whether the corporation has enough cash to distribute its AAA during the PTTP. If the corporation cannot distribute its AAA during the PTTP, any remaining AAA is reset to zero.[44]

Under the TCJA, an S corporation that satisfies certain requirements can treat distributions after the PTTP as coming proportionately from AAA and from accumulated E&P. That means that distributions to the extent of the shareholder's basis are tax-free to the shareholder.[45]

Observation. Under certain circumstances, it could be worthwhile to generate funds to use to distribute AAA tax-free during the PTTP.

SUSPENDED LOSSES

If an S corporation shareholder has a suspended loss in the last S corporation year because they had zero stock basis, the loss can be utilized on the last day of the PTTP to the extent the shareholder has reestablished basis in the corporate stock. Debt basis does not count for this purpose.[46] If the shareholder needs to create additional basis to take advantage of this rule, they may be able to make a capital contribution.

Observation. The best entity choice, post-TCJA, depends upon numerous factors in addition to tax. The most appropriate entity choice in any given situation is highly fact-dependent.

TAX-FREE INCORPORATION RULES

If it is determined that a conversion to, or the formation of, a corporation would be beneficial under the rules that apply after the TCJA enactment, incorporation of an existing business can be accomplished tax-free. A tax-free incorporation is usually desirable. This is particularly the case when property that will be transferred to the newly formed corporation has a fair market value (FMV) substantially in excess of basis. Often this built-in appreciation is the result of substantial amounts of depreciation that was taken on assets that will be transferred to the corporation.

For property conveyed to the corporation, neither gain nor loss is recognized on the exchange if three conditions are met.[47]

1. The transfer must be solely in exchange for corporate stock (not including "nonqualified preferred stock").[48]
2. The transferor (or transferors as a group) must be "in control" of the corporation immediately after the exchange. This requires that the transferors of property have at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all classes of stock.
3. The transfer must be for a "business purpose."

Note. "Persons" who can make a tax-free transfer to a controlled corporation include individuals, estates, trusts, partnerships, associations, companies, or corporations.[49]

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44. CCA 201446021 (Jul. 23, 2014).
45. IRC §1371(f). This applies to S corporations revoking their S election within two years of December 22, 2017. IRC §481(d)(2).
46. IRC §1366(d)(3)(A).
47. IRC §351.
48. If other property (including cash and securities) is also received, gain is recognized to the transferor, but only to the extent of the other property.
49. Treas. Reg. §1.351-1(a)(1).

Example 3. Ralph owns a commercial building with an adjusted basis of $100,000 and a $200,000 FMV. Rachel owns patents with an FMV of $50,000 and a basis of $5,000. Ralph and Rachel form the R&R Corporation. Ralph transfers his building to the corporation, and Rachel transfers her patent to the corporation. In exchange, Ralph receives 80% of the capital stock that the corporation issues, and Rachel receives 20% (none of which is nonqualified preferred stock). Neither Ralph nor Rachel recognize gain on the transfer.

Because of the 80% control test, if it is desirable to have a tax-free incorporation, there can be no substantial stock gifting occurring simultaneously with, or near the time of, incorporation. For example, parents who transfer all of their property to a corporation can lose the tax-free exchange status by gifting more than 20% of the corporate stock to children and other family members simultaneously with incorporation or shortly thereafter.

Note. There is no bright-line rule to determine the waiting period before gifts of stock can be made. Certainly, the longer the period, the better. In addition, shareholder agreements that require stock to be sold upon the transfer of property to a corporation should be avoided.[50]

It is the persons making the transfer who must be in control immediately after the transfer. Furthermore, they must satisfy the control requirement immediately following **any transfer to a corporation,** not just the initial transfer when the corporation is formed. Thus, the fact that the control requirement may have been satisfied on an earlier transfer does not mean it will be satisfied on a subsequent transfer. This is the problem of so-called "midstream" transfers (i.e., those occurring after the initial incorporation).

Example 4. Andy and Bailey form a corporation, with each contributing appreciated property to the corporation in exchange for 50 shares of its stock. Because both make contributions as part of the same overall transaction, their shares are aggregated for purposes of the control test. Therefore, they satisfy that test because they are treated as owning 100% of the stock immediately after the transfer.

Example 5. Use the same facts as **Example 4.** Three years after the initial incorporation, Bailey transfers additional appreciated property to the corporation in exchange for another 50 shares of stock. Because this is a separate transfer, Bailey must be in control of the corporation immediately after the transfer or be part of a control group, all the members of which also make transfers of property in exchange for stock. Because Andy does not make a transfer, his shares cannot be aggregated with Bailey's shares in determining control. Therefore, Bailey fails the control requirement because she has only two-thirds of the stock immediately after the transfer. Consequently, the transfer is taxable to Bailey, who is treated as having sold the property to the corporation for its FMV.

Observation. A possible solution to the control problem in **Example 5** might be to have Andy also make a transfer of property in exchange for additional shares. In this regard, the regulations under IRC §351 state that transfers of property that is of relatively small value in comparison to the value of stock already owned is ignored if the primary purpose of the transfer is to qualify another person's property transfers under IRC §351.[51] Because this standard is so subjective — **requiring that the primary purpose be tax avoidance** — it should be fairly easy to circumvent by, for example, establishing a valid business purpose for making a relatively nominal transfer. Recognition of gain could also be avoided by treating the transfer as an additional capital contribution instead of as an exchange for new stock. Therefore, the problem with midstream transfers is a failure to recognize at the time of the transfer that there is a problem that could potentially be avoided.

50. See, e.g., Ltr. Rul. 9405007 (Oct. 19, 1993).

51. Treas. Reg. §1.351-1(a)(1)(ii).

Lack of control can also be a problem if a new shareholder is brought into a corporation and contributes appreciated property in exchange for stock.

Example 6. Andrea is the sole shareholder of an existing corporation. Andrea and Brad agree that Brad will contribute appreciated property to the corporation in exchange for shares equal to the number already owned by Andrea. Because Brad will not be in control of the corporation immediately after the transfer, it is taxable to him.

Control is an issue only when appreciated property is transferred in exchange for stock. It is not an issue when cash is paid. In addition, if property is transferred to a corporation that has basis in excess of its FMV, failing the control requirement can be beneficial in allowing recognition of the loss.

Example 7. Use the same facts as **Example 6,** except the property transferred by Brad has an FMV of $75 and an adjusted basis in Brad's hands of $100. Because the control requirement is not satisfied, IRC §351 is not applicable. Therefore, Brad can recognize the $25 loss.

INCOME TAX BASIS UPON INCORPORATION

The income tax basis of stock received by the transferors is the basis of the property transferred to the corporation, less boot received, plus gain recognized, if any.[52] If the corporation takes over a liability of the transferor, such as a mortgage, the amount of the liability reduces the basis of the stock or securities received.[53] Debt securities are automatically treated as boot on the transfer unless they are issued in a separate transaction for cash. The corporation's income tax basis for property received in the exchange is the transferor's basis plus the amount of gain, if any, recognized to the transferor.[54]

WHEN IS INCORPORATION A TAXABLE EVENT?

When a person transfers property to a controlled corporation and the controlled corporation assumes a liability of the transferor, the liability assumed is generally not considered cash or other property for purposes of the IRC §351 requirement that the transferor receive only stock of the transferee corporation. Consequently, no gain is recognized.[55]

Example 8. Use the same facts as **Example 3,** except Ralph contributes the building to the corporation subject to a $25,000 liability. The corporation's assumption of liability does not result in gain recognition by Ralph because Ralph's basis of $100,000 exceeds the liability that the corporation assumed. Ralph's basis is reduced to $75,000.

Note. If, in connection with the transfer of property to a controlled corporation, the transferor's principal purpose for the controlled corporation's assumption of the transferor's liability is avoidance of federal income tax on the exchange,[56] or is not for a bona fide business purpose, then the total amount of the assumed liability is treated as money received by the transferor on the exchange.[57] The result, then, is that **all** liabilities assumed from the shareholder are treated as money, not just those in excess of basis.[58]

52. IRC §351(b).

53. IRC §357(c). This can be a trap upon incorporation due to the combination of accelerated depreciation at a rate exceeding the repayment of debt used to acquire the depreciated property and the tendency to keep real estate (with high basis) out of the corporation.

54. IRC §351(b).

55. IRC §357(a). The provisions of IRC §357(a) also apply when a corporation, a party to a reorganization, exchanges property in pursuance of a plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. IRC §361.

56. IRC §357(b)(1)(A).

57. IRC §357(b)(1)(B).

58. Treas. Reg. §1.357-1(c).

If the sum of the liabilities assumed by the corporation exceeds the aggregate basis of assets transferred, the excess is a taxable gain.[59] When a person transfers more than one property to a controlled corporation, the liabilities in excess of basis are determined by adding assumed liabilities and deducting the sum of the bases of all the transferred properties from this total. The excess, if any, is recognized as gain on the transfer.[60] The total recognized gain is allocated ratably over the various items of property (both capital and noncapital assets, and both short-term and long-term capital assets) transferred in accordance with their FMVs.[61]

Example 9. Use the same facts as **Example 8,** except the debt on Ralph's building is $110,000. The contribution of the building to the corporation was not made to avoid income tax, and Ralph had a valid business purpose in making the contribution. Ralph's basis in the building is $100,000. Therefore, the liability contributed exceeds the basis by $10,000. Ralph reports the excess $10,000 as taxable gain on Form 4797, *Sales of Business Property.* Ralph has a zero basis in the stock he received in the exchange.

Recourse and Nonrecourse Liabilities

The rules determining whether a liability is "assumed" differ depending on whether the debt is recourse or nonrecourse. A **recourse** liability is treated as having been assumed if, based on all the facts and circumstances, the transferee has agreed to, and is expected to, satisfy the debt. It is immaterial whether the transferor has been relieved of the liability.[62]

Example 10. Rennae operates her business as a sole proprietorship. The basis in her business assets is $300,000 and the liabilities are $500,000. She transfers the business assets to a corporation in exchange for all of the corporate stock in an IRC §351 transaction. Rennae enters into an agreement with the corporation and her creditor that she will pay the principal amount along with interest on the $200,000 of liabilities that exceed basis. As a result, the corporation is treated as assuming $300,000 of liabilities. Because the corporation has not assumed liabilities in excess of basis, Rennae does not recognize gain on the transaction.

A **nonrecourse** liability is treated as having been assumed by the transferee of any asset subject to such a liability.[63] However, the amount of the liability treated as assumed must be reduced to reflect the value of any other assets subject to the same nonrecourse liability that have not been transferred to the transferee. The required reduction is the lesser of the amount of the nonrecourse liability that the owner of the other assets has agreed with the transferee to satisfy, and is expected to satisfy, or the FMV of the other nontransferred assets, determined without regard to IRC §7701(g).[64] IRC §7701(g) requires that, in determining gain or loss with respect to property, the property's FMV is treated as not less than the amount of any nonrecourse liabilities to which the property is subject.

Example 11. Tracy owns two buildings that are both subject to a blanket nonrecourse mortgage of $400,000. The FMV of building #1 is $500,000, and the FMV of building #2 is $200,000. Tracy transfers the buildings to her newly formed corporation. There is no agreement as to the assumption of the nonrecourse liability. Thus, the corporation is treated as having assumed the entire mortgage.

If, however, Tracy retains building #2 and agrees to satisfy (and is expected to satisfy) $250,000 of the liability, the corporation is treated as having assumed only $150,000 of the mortgage ($400,000 – $250,000). This is the lesser of the $150,000 that the corporation agreed to pay, and the $200,000 FMV of the retained building.

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59. IRC §357(c). The gain is capital gain if the property is a capital asset or ordinary gain if the property is not a capital asset. IRC §357(c)(1).

60. Treas. Reg. §1.357-2(a).

61. Treas. Regs. §§1.358-1 and 1.357-2.

62. IRC §357(d)(1)(A).

63. IRC §357(d)(1)(B).

64. IRC §357(d)(2).

Excluded Liabilities

When determining the amount of liabilities in excess of basis that results in gain recognition, the computation excludes liabilities that:

- Give rise to a deduction (accounts payable, interest, or taxes),[65]
- Give rise to a capital expenditure, or[66]
- Are for payments to a retiring or deceased partner's successor in interest.[67]

> **Observation.** Bonus depreciation and expensing under IRC §179 may have been taken on equipment, which may result in little or no remaining tax basis. This, combined with an operating line-of-credit, prepaid expenses, and deferred income, may result in taxable income recognition upon the incorporation, particularly the incorporation of a farm. Thus, for those individuals who have refinanced and have increased their debt level to an amount that exceeds the income tax basis of the property, a later disposition of the property by installment sale or transfer to a partnership or corporation triggers taxable gain as to the excess.[68] For more information about the assumption of liabilities by a partnership, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Partnership Issues.

Technique to Avoid Tax

The issue of liability in excess of basis has led to creative planning techniques in an attempt to avoid the taxable gain incurred upon incorporation. One of these strategies involves the transferor giving the corporation a personal promissory note for the difference between liability and basis and then claiming a basis in the note equivalent to the note's face value. The IRS ruled that this technique is unacceptable because the note has a zero basis.[69]

In 1989, in *Lessinger v. Comm'r,*[70] a court held that a shareholder's personal note, while having a zero basis in the shareholder's hands, had a basis equivalent to its face amount in the corporation's hands. However, this is not a view held by other courts that have addressed the issue.

For example, in *Peracchi v. Comm'r,*[71] the taxpayer contributed two parcels of real estate to the taxpayer's closely held corporation. The transferred properties were encumbered with liabilities that together exceeded the taxpayer's total basis in the properties by more than $500,000. In order to avoid immediate gain recognition as to the amount of the excess liabilities, Mr. Peracchi also executed a promissory note, promising to pay the corporation $1.06 million over a term of 10 years at 11% interest. Mr. Peracchi remained personally liable on the encumbrances even though the corporation took the properties subject to the debt. He did not make any payments on the note until after being audited, which was approximately three years after the note was executed. The IRS argued that the note was not genuine indebtedness and should be treated as an enforceable gift. In the alternative, the IRS argued that even if the note were genuine, its basis was zero because Mr. Peracchi incurred no cost in issuing the note to the corporation. As such, the IRS argued, the note did not increase Mr. Peracchi's basis in the contributed property.

65. IRC §357(c)(3)(A)(i).

66. Rev. Rul. 95-74, 1995-2 CB 36.

67. IRC §357(c)(3)(A)(ii).

68. Installment sale gain is determined on the basis of the amount realized. That may not be the same thing as the amount of liabilities encumbering the property. If the liabilities are recourse and the buyer does not assume them because the FMV is less than the liabilities, the seller remains liable for the unpaid liabilities but determines gain only with respect to the FMV.

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

70. *Lessinger v. Comm'r,* 872 F.2d 519 (2d Cir. 1989), *rev'g* 85 TC 824 (1985).

71. *Peracchi v. Comm'r,* 143 F.3d 487 (9th Cir. 1998), *rev'g* TC Memo 1996-191 (Apr. 22, 1996).

The *Peracchi* court held that Mr. Peracchi had a basis of $1.06 million, which was the face value of the note. Accordingly, the aggregate liabilities of the property contributed to the corporation did not exceed aggregate basis and no gain was triggered. The court reasoned that the IRS's position ignored the possibility that the corporation could go bankrupt, an event that would suddenly make the note highly significant. The court also noted that Mr. Peracchi and the corporation were separated by the corporate form, which was significant in the matter of C corporate organization and reorganization. Contributing the note placed a million dollar "nut" within the corporate "shell," according to the court, thereby exposing Mr. Peracchi to the "nutcracker" of corporate creditors in the event the corporation went bankrupt. Without the note, the court reasoned, no matter how deeply the corporation went into debt, creditors could not reach Mr. Peracchi's personal assets. With the note on the books, however, creditors could reach into his pocket by enforcing the note as an unliquidated asset of the corporation.

The court noted that, by increasing Mr. Peracchi's personal exposure, the contribution of a valid, unconditional promissory note had substantial economic effect reflecting true economic investment in the enterprise. The court also noted that, under the IRS's theory, if the corporation sold the note to a third party for its FMV, the corporation would have a carryover basis of zero and would have to recognize $1.06 million in phantom gain on the exchange even if the note did not appreciate in value at all. The court reasoned that this simply could not be the correct result.

The court also observed that Mr. Peracchi was creditworthy and likely to have funds to pay the note. The note bore a market rate of interest related to his creditworthiness and had a fixed term. Additionally, nothing suggested that the corporation could not borrow against the note to raise cash. The court also pointed out that the note was fully transferable and enforceable by third parties.

The court did acknowledge that its assumptions would fall apart if Mr. Peracchi was not creditworthy, but the IRS stipulated that his net worth far exceeded the value of the note. This seems to be a key point that the court overlooked. If Mr. Peracchi was creditworthy, then a legitimate question exists concerning why he failed to make payments on the note before being audited.[72]

Note. After *Lessinger* and *Peracchi* were decided, IRC §357 was amended to include subsection (d). That subsection specifies that a recourse liability is treated as having been assumed if the facts and circumstances indicate that the transferee has agreed to, and is expected to, satisfy the liability (or a portion thereof) regardless of whether the transferor has been relieved of the liability. Nonrecourse liabilities are treated as having been assumed by the transferee of any asset subject to the liability.

The *Peracchi* court was careful to state that the court's rationale was limited to C corporations. Therefore, the opinion does not apply to S corporation shareholders attempting to create basis to permit losses to be passed through. However, Rev. Rul. 80-235[73] specifies that a partner in a partnership cannot create basis in a partnership interest by contributing a note.

Observation. Based on the preceding analysis, the IRS is likely to continue challenging "basis creation" cases on grounds that the contribution of a note is not a bona-fide transfer.

72. Clearly, the taxpayer never had any intention of paying off the note. Thus, a good argument could have seemingly been made that the note did not represent genuine indebtedness. The court also appears to have overlooked the different basis rules under IRC §§1012 and 351. An **exchanged** basis is obtained in accordance with an IRC §351 transaction, which precludes application of the basis rules of IRC §1012.

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

A similar technique designed to avoid gain recognition upon incorporation when liabilities exceed basis is for the transferors to remain personally liable on the debt assumed by the corporation, with no loan proceeds disbursed directly to the transferors. However, gain recognition is not avoided unless the corporation does **not** assume the indebtedness.[74]

A good rule of thumb is that property should never be transferred to a new entity without first determining whether there is enough basis to absorb the debt. If it is discovered that the debt exceeds the aggregate basis of the property being transferred to the entity, several options should be considered. These include not transferring some of the low-basis assets to the new entity or consulting with the lender and leaving some of the debt out of the entity, permitting it instead to remain with the individual shareholders, or having the shareholders later pledge their stock to secure the debt. Alternatively, cash can be contributed to the entity in lieu of some of the low-basis assets or in addition to the assets, because cash is all basis.

CONVERTING A C CORPORATION TO AN S CORPORATION

The 1986 Tax Reform Act[75] substantially changed tax law in the area of corporate liquidations. Generally, the liquidation of a C corporation results in double taxation (corporate and shareholder level) as a result of appreciation in the value of corporate assets from the inception of the corporation through the date of liquidation. Consequently, in some situations, it may be advisable to convert an existing C corporation to an S corporation by electing S corporation status. The election has the effect of locking in and limiting the total amount of gain that would be realized upon a liquidation of a C corporation.

> **Note.** Among other requirements, an S corporation is limited to 100 shareholders. For a complete list of requirements, see **uofi.tax/18b4x1** [www.irs.gov/businesses/small-businesses-self-employed/s-corporations].

The S election freezes the corporate built-in gain at a level that will not exceed the difference between the cost basis in the C corporation property and the FMV as of the effective date of the S election. Following this election, the corporation and shareholders avoid double taxation (corporate and shareholder level) on any additional appreciation in the FMV of the corporate property. In addition, if the corporation continues its corporate existence for a period of five years following the S election, the corporation and its shareholders avoid double taxation on the appreciation in value of corporate assets under the built-in gain rule.[76] The 5-year period begins with the first day of the first tax year for which the corporation was an S corporation.[77]

> **Observation.** S corporation net profits are reported to the shareholders on Schedule K-1 (Form 1120S), *Shareholder's Share of Income, Deductions, Credits, etc.* The net profits are subject to federal and state tax at the shareholder level. Distributions may be required to enable the shareholders to pay those taxes. While S corporations can retain net profits for equity financing, for example, doing so requires the shareholders to pay individual income tax on their share of the S corporation earnings from other sources.

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74. *Seggerman Farms, Inc. v. Comm'r,* 308 F.3d 803 (7th Cir. 2002), *aff'g* TC Memo 2001-99 (Apr. 25, 2001).

75. PL 99-514.

76. This is for purposes of federal tax. State-level tax rules may apply a different BIG period.

77. IRC §1374(d)(7).

THE BUILT-IN-GAIN ISSUE

At the time of the conversion from C to S status, built-in gain (BIG) is created when the corporation has assets that appreciated in value inside the corporation.[78] The BIG tax is imposed at the highest corporate tax rate if those assets are liquidated within the 5-year BIG recognition period. Thus, before the election is made, consideration should be given to liquidating assets that are likely to be sold within the 5-year period after the S election.

> **Example 12.** Industrial Tech, Inc., a C corporation, owns a crane with a zero basis and an FMV of $200,000 on January 1, 2017, the date that the corporation elects S status. Frank Ess is the sole shareholder. The asset was not liquidated prior to the corporation's S election.
>
> The crane is sold in 2018 for $200,000. The S corporation is required to pay BIG tax of $42,000 ($200,000 × 21% C corporation tax rate). Frank pays federal and state income taxes on the remaining $158,000 of gain ($200,000 – $42,000 BIG tax). Frank's federal marginal tax rate is 24% and his state marginal tax rate is 8%. Assuming the gain from the sale of the crane is QBI, Frank has a QBID of $31,600 ($200,000 – $42,000 basis = $158,000 × 20%). Therefore, Frank has ordinary gain of $126,400 ($158,000 – $31,600) taxed at 32%, resulting in $40,448 of tax. The combined tax rate pertaining to the sale of the crane is 41.22% (($42,000 corporation BIG tax + $40,448 shareholder tax) ÷ $200,000 sale price). The combined tax rate pertaining to the sale of the crane is 46.28% (($42,000 corporation BIG tax + $50,560 shareholder tax) ÷ $200,000 sale price).

Following the S election, the corporation and its shareholders bear the burden of determining the amount of net unrealized built-in gain (NUBIG) or loss, which is the net amount of built-in gain or loss on each of the corporation's assets. The corporation's exposure to the BIG tax is limited to the amount of NUBIG.[79] Accordingly, it is necessary to have the corporate assets appraised (as of the date of the S election) to determine the NUBIG as of the date of the S election.

> **Note.** The timing of the election can be a particular issue for certain types of C corporations. For example, for farm corporations, it is usually best to consider an S election after harvest and before planting to avoid any growing crop issues. However, growing crops that will ultimately be sold as inventory during the 5-year recognition period should not constitute separate assets on the conversion date and, thus, should not be subject to the IRC §1374 BIG rules.[80]

BIG Tax Rate and Computation

A corporate level tax is imposed by IRC §1374 on any net recognized built-in gain occurring in any tax year during the 5-year recognition period. The BIG tax is in addition to the regular taxation that is imposed upon sale of the asset. The BIG tax is equal to the highest corporate rate. As mentioned earlier, that rate is 21% for tax years beginning after 2017.[81] The BIG tax applies to any asset carried over from a C corporation that is disposed of within the 5-year recognition period.

The built-in gain for each asset liquidated is limited to its net unrealized gain (FMV minus adjusted tax basis), as measured on the date on which the S election takes effect.[82] Any BIG tax liability is treated as a reduction in the S corporation's taxable income for the year of recognition.[83] However, the gain that is taxed is limited to the amount of tax that would be due if the corporation had filed as a C corporation.[84] Thus, if the S corporation's taxable income is zero throughout the 5-year period after the election, the BIG tax is eliminated.

78. IRC §1374.
79. IRC §1374(c)(2).
80. See Rev. Rul. 2001-50, 2001-2 CB 343. The ruling dealt with timber, coal, and iron ore sales during the BIG recognition period.
81. The BIG tax rate at the state level will likely be different than the federal 21% rate.
82. IRC §1374(d)(1).
83. IRC §1366(f)(2); Treas. Reg. §1.1366-4(b).
84. IRC §1374(d)(2).

If S corporation income cannot be held to zero in the 5-year period after the S election, the net impact of the BIG tax on both ordinary items and capital gain is illustrated in the following table.[85]

BIG Tax on Ordinary Income Items

Individual Tax Rate	Gain	C Corporation Tax on Gain (21%)	Net After Corporation Tax	Times Individual Tax Rate	Net After Tax	No BIG Tax	Cost of BIG Tax
10%	$1,000	($210)	$790	($ 79)	$711	$900	$189
12%	1,000	(210)	790	(95)	695	880	185
22%	1,000	(210)	790	(174)	616	780	164
24%	1,000	(210)	790	(190)	600	760	160
32%	1,000	(210)	790	(253)	537	680	143
35%	1,000	(210)	790	(277)	513	650	137
37%	1,000	(210)	790	(292)	498	630	132

BIG Tax on Capital Gain Items

Individual Tax Rate	Gain	C Corporation Tax on Gain (21%)	Net After Corporation Tax	Times Individual Tax Rate	Net After Tax	No BIG Tax	Cost of BIG Tax
0%	$1,000	($210)	$790	$ 0	$790	$1,000	$210
15%	1,000	(210)	790	(119)	671	850	179
20%	1,000	(210)	790	(158)	632	800	168

Recognized built-in gains may be offset by the C corporation's net operating loss (NOL) carryovers or capital loss carryovers that had not been used at the date of the conversion to an S corporation. These losses can be carried forward indefinitely.[86]

A special rule applies for installment sales. Generally, if an S corporation sells property with built-in gain 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 5-year recognition period.[87]

Strategies for Avoiding the BIG Tax

If the S corporation's shareholders liquidate some or all of the corporation's property within the 5-year recognition period, it may be possible to avoid the BIG tax by utilizing one of several possible alternatives.

Corporate Stock Sale. 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 BIG tax recognition period. The purchaser of the stock is responsible for any BIG taxation.

> **Note.** A buyer of corporate stock subject to a BIG tax recognition period will likely require a significant discount from FMV when negotiating the purchase price of the stock.[88]

85. Courtesy of Paul Neiffer, Principal, CliftonLarsonAllen, LLP.

86. IRC §1374(b)(2).

87. Treas. Reg. §1.1374-10(b)(4).

88. For cases involving the discounting of stock to reflect potential BIG tax, see, e.g., *Estate of Richmond v. Comm'r,* TC Memo 2014-26 (Feb. 11, 2014); *Estate of Dunn v. Comm'r,* 301 F.3d 339 (5th Cir. 2002); *Estate of Jelke v. Comm'r,* 507 F.3d 1317 (11th Cir. 2007); *Estate of Eisenberg v. Comm'r,* 155 F.3d 50 (2d Cir. 1998); *Estate of Welch v. Comm'r,* 208 F.3d 213 (6th Cir. 2000); *Estate of Davis v. Comm'r,* 110 TC 530 (1998); and *Estate of Jensen v. Comm'r,* TC Memo 2010-182 (Aug. 10, 2010).

Like-Kind Exchange of Real Estate. Real estate acquired in a like-kind exchange whose basis is determined, in whole or in part, by reference to the basis of an asset that was held by a C corporation when it became an S corporation is treated as being held by the S corporation at the time of conversion.[89] Thus, real estate subject to the 5-year BIG recognition rule can be exchanged for similar "like-kind" real estate without triggering the BIG tax (e.g., real estate exchanged for an apartment building or other urban rental real estate, etc.). The exchanged asset continues to be subject to BIG taxation for the remainder of the 5-year recognition period.

> **Note.** Under the TCJA, like-kind exchanges of **personal property** are no longer allowed under IRC §1031. Personal property exchanges of S corporation assets within the 5-year period after electing S status trigger BIG tax at the 21% federal rate and at the applicable state rate. The BIG tax reduces the flow-through income reported on the S corporation shareholder's individual return.

Long-Term Lease. Shareholders may be able to enter into a long-term lease of corporate assets with an option to the buyer for purchase of the assets after the 5-year BIG recognition period expires.

> **Note.** Care should be taken in drafting the lease agreement so that it does not constitute a sale for federal income tax purposes and to avoid exposure to various passive income tax problems.

Zeroing-Out S Corporation Income. As mentioned earlier, if S corporation income can be kept to zero throughout the 5-year period after the election, the BIG tax is eliminated. Specifically, net recognized built-in gain for any tax year is the **lowest** of the following three amounts.[90]

1. The total remaining NUBIG resulting from the S corporation conversion
2. The amount of recognized built-in gain during the tax year (pre-limitation amount)
3. The S corporation's taxable income for the tax year

Therefore, if shareholders must liquidate some or all of the corporation's assets within the 5-year BIG recognition period, the corporation may still avoid payment of the BIG tax if the S corporation's taxable income can be reduced to zero for the year of recognition and each subsequent tax year during the 5-year recognition period. Strategies for achieving this can include deferring income, increasing salaries or bonuses, and accelerating expenses.

Any net recognized built-in gain on which tax is not paid during a tax year carries over to each subsequent tax year during the 5-year recognition period. Thus, the net recognized BIG tax will be paid in a subsequent year unless the S corporation's taxable income can also be lowered to zero for those tax years.

If an S corporation's taxable income can be reduced to zero for each tax year during the 5-year recognition period, the BIG tax that would apply to recognized built-in gains carried over from prior tax years will be eliminated forever. The only exception to this is for recognized built-in gains under installment sales, as previously discussed.

Once the net recognized built-in gain is established for a tax year and the BIG tax computed, it may be possible to offset the tax with any business credit carryforward and/or AMT credit that remains available and unused from a C corporation tax year.[91] The S corporation must observe any limitations (e.g., carryover limitations, etc.) that apply to these credits. No other credit is available to offset the BIG tax (except gas tax credits reported on Form 4136, *Credit for Federal Tax Paid on Fuels)* for the S corporation year. All other credits pass through to S corporation shareholders.

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89. IRC §1374(d)(6).

90. IRC §1374(d)(2).

91. IRC §1374(b)(3).

PASSIVE INCOME ISSUES

While S corporations are not subject to the AET or the PHC tax (discussed earlier), S corporations that have E&P from prior C corporation years are subject to certain limits on passive investment income.[92] Under IRC §1375, a tax is imposed at the highest corporate rate (21% for years starting after 2017) on excess net passive income[93] if the corporation has C corporation E&P at the end of the tax year and greater than 25% of its gross receipts are from passive sources of income.[94]

If passive income exceeds the 25% limit for three years, the S election automatically terminates. The corporation reverts to C corporation status immediately at the end of that third tax year.[95]

Strategies to Avoid Passive Income Problems

There are several strategies that can be used to avoid passive income problems.

Prepaying Expenses. The S corporation can avoid reporting any excess net passive income if the corporation is able to prepay sufficient expenses to offset all passive investment income and/or create negative net passive income.

Distribution of E&P. The corporation may be able to distribute all accumulated C corporation E&P to shareholders before the end of the first S corporation year.[96] However, corporate shareholders then have to deal with the income tax liability incurred upon the distribution of C corporation E&P unless the corporation is liquidated. Generally, distributions of C corporation E&P should occur when income taxation to the shareholders can be minimized.[97]

Note. In order to make a distribution of accumulated C corporation E&P, an S corporation with an accumulated adjustments account (AAA) can, with the consent of all shareholders, treat distributions for any year as coming first from the C corporation's E&P instead of the AAA.[98]

Deemed Dividend Election. If the corporation did not have sufficient cash to pay out the entire accumulated C corporation E&P, the corporation may make a deemed dividend election under Treas. Reg. §1.1368-1(f)(3). The consent of all affected shareholders is required to make this election. Under this election, the corporation can be treated as having distributed all or part of its accumulated C corporation E&P to the shareholders as of the last day of its tax year. The shareholders, in turn, are deemed to have contributed the amount back to the corporation in a manner that increases stock basis.

Observation. With the increased stock basis, the shareholders can extract these proceeds in future years without additional taxation, as the S corporation's cash flow permits.

92. IRC §1362.
93. As defined by IRC §1375(b)(1).
94. Ibid.
95. IRC §1362(d)(3).
96. IRC §1375(a)(1).
97. Consideration should be given to the effect that the distribution of E&P has upon the taxability of social security benefits for older shareholders.
98. IRC §1368(e)(3).

The election for a deemed dividend is made by attaching an election 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). Each shareholder who is deemed to receive a distribution during the tax year must consent to the election. Furthermore, the election must include the amount of the deemed dividend that is distributed to each shareholder.[99]

> **Note.** S corporation distributions are normally taxed to the shareholders as ordinary income dividends to the extent of accumulated E&P after the AAA and previously taxed income (pre-1983 S corporation undistributed earnings) have been distributed.[100] 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.

A 20% tax rate applies to qualified dividends if the shareholder's 2018 AGI is greater than $479,000 for MFJ taxpayers, $425,800 for single taxpayers, $452,400 for HoH taxpayers, or $239,500 for MFS taxpayers.[101] In addition, the 3.8% net investment income tax (NIIT) applies to qualified dividends if AGI exceeds $250,000 for MFJ taxpayers or $200,000 for single or HoH taxpayers.[102] However, if accumulated C corporation E&P can be distributed while minimizing shareholder tax rates (keeping total AGI below the NIIT thresholds and avoiding AMT), qualified dividend distributions may be a good strategy.

The deemed dividend election can be for **all or part** of E&P. Furthermore, the deemed dividend election automatically constitutes an election to distribute E&P first, as discussed earlier. The corporation may therefore be able to distribute sufficient cash dividends to the shareholders for them to pay the tax and to treat the balance as the deemed dividend portion. This can make it more affordable to eliminate or significantly reduce the corporation's E&P.

> **Observation.** If the shareholder's total AGI can be maintained below the NIIT thresholds and below those levels at which AMT applies, the highest effective federal tax rate for 2018 after C corporate dividends would be 32.85% if all corporate net income had been previously taxed at a 21% federal rate (i.e., 21% corporate income tax rate + (79% × 15% dividend rate) = 32.85% effective federal tax rate to shareholders).

Modification of Rental Arrangements. 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 provided or substantial costs are incurred is a facts and circumstances determination.[103] The significant services test can be met by entering into a lease that requires significant management involvement by the corporate officers supported by significant management activity by the officers.

> **Observation.** For farm C corporations that convert to S corporations, consideration should be given to entering into a net crop share lease (while retaining significant management decision-making authority) upon making the S election, as an alternative to a cash rent lease or a 50/50 crop share lease. Some form of bonus bushel clause is usually added to a net crop share lease in case a bumper crop is experienced or high crop sale prices result within a particular crop year. Net crop leases in the Midwest, for example, normally provide the landlord with approximately 30 to 33% of the corn and 38 to 40% of the beans grown on the real estate.[104]

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99. Treas. Reg. §1.1368-1(f)(5).

100. IRC §1368.

101. IRC §1(j)(5).

102. IRC §1411.

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

104. Because crop-share income is generally not considered "passive" (if the significant management involvement test can be met), a net crop-share lease should allow the corporation to limit involvement in the farming operation. It can also avoid passive investment income traps unless the corporation has significant passive investment income from other sources (interest, dividends, etc.) such that passive investment income still exceeds 25% of gross receipts.

Gifts to Children. Gifts of stock to children or grandchildren can be considered so that dividends paid are taxed to those in lower tax brackets. However, tax benefits may be negated for children and grandchildren up to the ages of 18–23 if they receive sufficient dividends to cause the "kiddie" tax rules to be invoked.

Distributions in Redemption of Stock. A corporation may redeem a portion of the stock held by a deceased shareholder and treat the redemption as a capital gain redemption to the extent that the amount of the redemption does not exceed the sum of estate taxes, inheritance taxes, and the amount of administration expenses of the estate.[105] The capital gain reported is usually small or nonexistent due to the step up in basis of a shareholder's stock at the date of death.[106]

QUALIFIED SUBCHAPTER S TRUST

Once S corporate status is elected, this classification can only be retained by a corporation having appropriate shareholders. After the death of a spouse, the portion of corporate stock held in a bypass trust can only qualify as an acceptable S corporation shareholder if the trust meets the definition of a qualified subchapter S trust (QSST), as follows.[107]

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

Note. If a trust meets the definition of a QSST, an appropriate S corporate election under IRC §1361(d)(2) should be made.

MINIMIZING SOCIAL SECURITY TAX

Although both the pass-through income of an S corporation and a salary payment from an S corporation are ultimately taxable to the owner-employee at ordinary income rates, their treatment is not identical. An S corporation's pass-through income (dividend distributions), while treated as ordinary income, is **not** subject to social security taxes.[108] The distinction can be significant. Social security taxes include a 12.4% tax on amounts up to the social security wage base of $128,400 (for 2018).[109] A 2.9% Medicare tax also applies, with no wage base limitation. In addition, a 0.9% Medicare surtax applies to earned income above $200,000 for single taxpayers, or $250,000 for MFJ taxpayers.[110] Thus, the social security tax rate is 15.3% initially, 2.9% above $128,400, and then 3.8% (2.9% + 0.9%) for income above $200,000 (or $250,000 for MFJ).

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105. IRC §303. IRC §303 does not operate any differently with an S corporation than a C corporation.

106. IRC §1014.

107. IRC §§1361(d)(3)–(4).

108. Rev. Rul. 59-221, 1959-1 CB 225.

109. *Contribution and Benefit Base.* Social Security Administration. [www.ssa.gov/oact/cola/cbb.html] Accessed on May 18, 2018.

110. IRC §1401(b)(2)(A).

It is not possible to structure all S corporation compensation as dividend distributions to avoid the payment of social security tax. Salaries are required to be **reasonable** for the personal services actually rendered.[111] The Code does not define "reasonable." The regulations provide only that reasonable compensation is an amount paid for like services by like enterprises under like circumstances.[112] Each situation must be addressed based on its unique facts and circumstances.

The courts have enumerated a number of factors to use to determine the reasonableness of salaries.[113]

1. Reasonable considering the employee's qualifications (training, experience)
2. Reasonable considering the nature and extent of the employee's work (considering the role the shareholder plays in the corporation, including their position, hours worked, and duties performed)
3. Reasonable in comparison to compensation paid for similar services by similar entities
4. Reasonable in relation to salary history of the entity (considering the corporation's compensation policy for all employees and the shareholder's individual salary history, including the corporation's internal consistency in establishing the shareholder's salary)
5. Reasonable considering the character and financial condition of the corporation
6. Reasonable considering whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation

The courts have also considered additional factors in deciding whether the amount of compensation is reasonable.[114] These include the following.

- The size and complexity of the business
- A comparison of salaries paid to sales and net income
- General economic conditions
- Comparison of salaries 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

The court decisions confirm that no single factor controls; rather, a combination of factors must be considered. Furthermore, these factors are not all inclusive and may not be given equal weight. Fewer or additional factors may be appropriate, depending on the relevant facts and circumstances.

Observation. Before yearend, each shareholder/employee's compensation should be reviewed for reasonableness and should be increased by the payment of a yearend bonus, if needed. While reasonableness is based on the facts and circumstances, in many situations compensation can be set at the low end of a wide salary range that is both reasonable and supportable. The better the documentation (e.g., corporate minutes) explaining why wages and bonuses are appropriate, the more likely that the payments can withstand an IRS challenge.

Note. For more information on S corporations and reasonable compensation, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Entity Comparison.

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111. IRC §162(a)(1).

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

113. See, e.g., *H.L. Foos v. Comm'r,* TC Memo 1981-61 (Feb. 18, 1981).

114. Ibid.

LIQUIDATING THE S CORPORATION

Ignoring the C corporation E&P issue, taxation is generally minimized by waiting to liquidate the S corporation until the later of the death of the shareholder(s) **or** the expiration of the 5-year BIG recognition period.

At death, a decedent's stock ownership interest generally receives a stepped-up basis to FMV.[115] This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g. sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1), results in only one level of taxation being incurred on liquidation (at the shareholder level). Because stock basis is increased by death and pass-through of income, no actual realization of gain results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation, because the pass-through gain (reported on Schedule K-1) to the estate/heirs is offset by a matching loss from the liquidation of the stock.

Possible Ordinary Income Treatment

IRC §1239 was enacted to end the practice of selling or exchanging depreciable assets to a controlled corporation in order to establish a higher depreciation basis for capital gain purposes. Accordingly, IRC §1239 requires ordinary income treatment of any gain recognized from the sale or exchange of property, directly or indirectly, between related persons, if the property is of a character subject to depreciation in the hands of the transferee.

> **Note.** Property of a character subject to the allowance for depreciation includes IRC §197 intangibles.[116]

Related persons for purposes of IRC §1239 include the following.

- A person and all entities that are controlled entities with respect to such person (i.e., the individual directly or indirectly through attribution of ownership owns more than 50% of the value of the outstanding stock of the corporation)
- A taxpayer and any trust in which such taxpayer is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate (For this purpose, related beneficiaries include those individuals defined as related parties under IRC §267(c)(4).)

Under IRC §1239, when depreciable property is involved in a liquidation, a shareholder who is a related party to the liquidating corporation will realize ordinary income upon a sale or exchange to the extent of any depreciation recapture.

> **Note.** When the assets of a corporation are liquidated upon the death of a shareholder (or at any other time when related parties are involved), ordinary income is realized and recognized upon the distribution of certain depreciable property. This ordinary income is not completely offset by a capital loss recognized upon the liquidation of corporate stock.

115. IRC §1014.

116. IRC §197(f)(7).

Property Distributions

Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its FMV, pursuant to IRC §311(b). The corporation recognizes gain to the extent the property's FMV exceeds its adjusted basis. When appreciated property is distributed to an S corporation 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 whose 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 earlier. However, if the S corporation has more than one shareholder, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest results in a taxation event for all other corporate shareholders.[117]

> **Example 13.** Gadget Corp. has four equal shareholders. Mary, a shareholder who owns 25% of the S corporation's stock, dies. The corporation distributes real estate to Mary's estate in liquidation of her stock interest. Mary's estate reports 25% of any gain at distribution and can offset this taxable gain through a matching capital loss created by the liquidation of her stock in Gadget Corp. However, the other shareholders are responsible for paying tax on the remaining 75% of any gain.

> **Observation.** An alternative to avoid the taxation problem illustrated in this example is to simply have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate buy-sell agreement among the shareholders might be advantageous to accomplish the desired result.

A shareholder's income tax basis in property distributed by the corporation is the property's FMV at the date of distribution.[118] 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. Because the shareholder's basis in the property is its FMV (rather than a carryover of the corporation's basis), the corporation's holding period does not tack on to the shareholder's holding period. Thus, the redeeming shareholder must hold distributed property for one year after distribution to achieve capital gain tax treatment on a subsequent sale.

Divisive Reorganization

An alternative to liquidating the S corporation at the death of the surviving spouse is a divisive reorganization under IRC §355 (commonly referred to as a "split-off"). In a divisive reorganization, part of the assets of a parent corporation are split-off to one or more former shareholders through a new corporation. A divisive reorganization typically involves three major steps, as follows.

1. Formation of a new corporation (functions like a subsidiary)
2. Transfer of part of the parent corporation's assets to the subsidiary (usually tax-free)
3. Distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation

A divisive reorganization can be used to divide a single, functionally integrated business into two separate businesses and allows surviving shareholders to postpone income recognition that would otherwise occur through corporate liquidation at the death of the first-generation shareholders.[119]

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117. IRC §311(b).

118. IRC §301(b).

119. Treas. Regs. §§1.355-1(b) and 1.355-3(c), Examples 4 & 5. See also Rev. Rul. 75-160, 1975-1 CB 112; *Coady v. Comm'r,* 33 TC 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961); *U.S. v. Marett,* 325 F.2d 28 (5th Cir. 1963).

For a divisive reorganization to be tax-free, five tests under IRC §355 must be met.

1. A control test[120]
2. An **active conduct of a business** test
3. Distribution of stock or securities only
4. Parent corporation distributes all of the stock in the subsidiary (or enough for control)
5. Trade or business purpose (Reorganization must not be used primarily as a device for distribution of E&P.)

However, there are only two tests or requisites that generally create issues that prevent consideration of a divisive reorganization.

1. Active conduct of trade or business requirement (5-year pre-distribution and two or more years post-distribution)[121]
2. Trade or business purpose requirement

Active Conduct of a Trade or Business. For purposes of IRC §355, a trade or business must have been actively conducted by the distributing parent corporation throughout the 5-year period ending on the date of distribution. The regulations under IRC §355 expand this requirement and require continued operation of the business or businesses existing prior to the implementation of the divisive reorganization. Accordingly, a transitory continuation of one of the active businesses does not satisfy the active conduct of a trade or business test provided by these regulations.[122]

> **Note.** Holding stock and securities for investment purposes does not constitute the active conduct of a trade or business. Also, ownership and rental of real or personal property does not constitute the active conduct of a trade or business unless the owner performs significant services with respect to the operation and management of the property.[123]

For farming corporations, the requirement of an active conduct of a trade or business was satisfied in Rev. Rul. 73-234. It was not satisfied in Rev. Rul. 86-126.'

Rev. Rul. 73-234.[124] In this ruling, the taxpayer operated an insurance agency and owned 100% of the stock in a farming corporation. The taxpayer sought guidance on whether its intended distribution of the stock in the farming corporation to its sole shareholder (for valid business reasons) would qualify as a tax-free corporate split-off on the basis that the farming business constituted an active trade or business for purposes of IRC §355.

The farming activities were conducted by farm tenants under share arrangements on land that the farming corporation owned. The farming corporation employed a worker to maintain the farm property and equipment. The president and sole shareholder of the insurance agency (the parent corporation) was an experienced farmer. The farming corporation (subsidiary corporation) employed him to run the farming operation, and he did so by entering into agreements with the farm tenants, supplying all equipment and financing for the farming operation, planning the planting and harvesting of crops, and purchasing and planning the breeding of livestock. He also hired seasonal workers and made the decisions about when to sell crops and livestock.

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120. See IRC §§355(a)(1)(A) and 368(c).
121. IRC §355(b)(2); Rev. Proc. 2016-40, 2016-32 IRB 228.
122. IRC §355(b)(1)(A) and Treas. Reg. §1.355-3(a)(1).
123. Treas. Reg. §1.355-3(b)(2)(iv).
124. Rev. Rul. 73-234, 1973-2 CB 180.

The IRS noted that the active business requirement of IRC §355 required that the corporation itself conduct the farming business as opposed to independent contractors. However, the IRS stated that "the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions." The IRS determined, based on the facts presented, that the activities that the farming corporation conducted through its employees constituted "substantial management and operational functions apart from those activities performed by tenant farmers." As a result, the IRS determined that the sole shareholder satisfied the active business requirement of IRC §355.

Rev. Rul. 86-126.[125] A corporation wanted to transfer half of its property to a newly created subsidiary, followed by the distribution of the subsidiary's stock to one of the corporation's shareholders. The corporation was owned equally by two shareholders (who were also corporate officers) and held large tracts of farmland. The shareholders were independent farmers who farmed their own land and served as corporate officers. The corporate farmland was leased to tenants under a 50/50 arrangement: all farm income and expenses were shared equally. The tenants were responsible for obtaining financing necessary for their share of farming expenses, and the tenants did all of the planting, raising, and harvesting of the crops. The tenants also supplied the equipment that was used in farming the corporation's land and maintained the equipment and irrigation system. The shareholders consulted with the tenants regarding the purchase of herbicides, insecticides, and fertilizer. They also consulted with the tenants before the tenants contracted to sell the crops and before the tenants provided an accounting of the proceeds to the corporation (which the shareholders subsequently reviewed).

On behalf of the corporation, the shareholders periodically inspected the crops and improvements located on the leased land. They notified the tenants of any issues and the tenants made the necessary corrections. The shareholders decided what portion of the corporation's land to lease based on soil conservation, markets, and federal farm programs.

The IRS determined that the active business requirement of IRC §355 was not satisfied. The IRS noted that the farming corporation did not engage in the managerial and operational activity of the farm to a sufficient degree to distinguish its involvement from a mere investor. Occasionally inspecting farmland and consulting with tenants was insufficient to satisfy the "substantial managerial and operational activities" test that had been set forth in Rev. Rul. 73-234.[126]

Note. It does not appear that the use of a farm manager (agent) to perform these services for the corporation necessarily impairs the active conduct of a trade or business requirement.[127] However, the officers and directors must be active in directing the actions of the agent, not mere spectators.

Observation. The activities of the corporation's officers and directors for the pre-distribution (five years) and post-distribution (two or more years) time frames should be well documented before a divisive reorganization is undertaken. Also, officers/directors should be paid reasonable salaries for services performed.

De Minimis Rule. While IRC §355 requires that the corporation seeking a divisive reorganization be engaged in the active conduct of a trade or business, it does not require that all assets of the corporation be devoted to or used in an active trade or business. The corporation may hold nonqualifying assets (generally less than 5% of total) as long as it is engaged in the active conduct of a trade or business.[128]

125. Rev. Rul. 86-126, 1986-2 CB 58.

126. Unfortunately, neither Rev. Rul. 73-234 nor Rev. Rul. 86-126 discussed the degree of involvement the shareholders expended in planning crop planting and rotation.

127. *Webster Corp. et al. v. Comm'r,* 25 TC 55 (1955), *acq.* 1960-2 CB 7, *aff'd* 240 F.2d 164 (2d Cir. 1957).

128. Treas. Reg. §1.355-3(a)(1)(ii).

Trade or Business Purpose. Treas. Reg. §1.355-2(b)(2) provides that a corporate business purpose under §355 must be a real and substantial nonfederal tax purpose germane to the business of both the distributing corporation and the controlled corporation. A shareholder purpose (e.g., accomplishing personal estate planning objectives), by itself, is not a corporate business purpose. However, the regulation explains that a shareholder purpose may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. In this case, the transaction meets the corporate business purpose requirement. A transaction motivated in substantial part by a corporate business purpose does not fail the business purpose requirement merely because it is motivated in part by a shareholder's nonfederal tax purpose.

The business purpose test generally is readily ascertainable (e.g., shareholder disputes or potential disputes, etc.). The following IRS rulings illustrate this point.

- Rev. Rul. 2003-52[129] involved a family farming corporation owned by a father, mother, and their two adult children, with active operation and management largely conducted by the two adult children. One child intended to focus on the livestock aspect of the corporate business; the other preferred to operate the grain farming enterprise. To allow each to devote their full attention to a single business strategy, the corporation reorganized into two corporations, with the son receiving the stock of the livestock business and the daughter receiving the stock of the grain enterprise. The IRS approved the reorganization, taking the position that it was motivated by substantial nontax business reasons even though the reorganization advanced the personal estate planning goals of the mother and father and promoted family harmony.
- Ltr. Rul. 200323041[130] involved separation of a grain farming business (land, etc.) between siblings following their father's death. The IRS determined that a corporate split-off undertaken to avoid shareholder disputes in a family-owned grain farming corporation (engaged in a single line of business) would constitute an IRC §368(a)(1)(D) reorganization and the stockholders of the split-off corporation would not recognize gain or loss pursuant to IRC §355.
- In Ltr. Rul. 200425033,[131] split-offs designed to resolve shareholder disputes that were having adverse effect on a corporation's business satisfied IRC §368(a)(1)(D).
- In Ltr. Rul. 200422040,[132] a family-owned S corporation split-off to avoid disputes and accomplish parental estate planning was approved by the IRS.
- In Ltr. Rul. 201219003,[133] the IRS approved a related-party S corporation (two shareholders) split-off to avoid future management disputes between shareholders and among their family members and to prolong the life of the corporation.
- In Ltr. Rul. 201402002,[134] the IRS approved a single business S corporation's (four equal shareholders) equal split-off into four separate corporations to allow each shareholder to independently own and manage a separate business according to his/her own goals and priorities.
- In Rev. Rul. 2003-55,[135] the IRS ruled that the post-distribution business-purpose requirement of Treas. Reg. §1.355-2(b) remained satisfied even though the business purpose could not be achieved due to an unexpected change in circumstances following a divisive reorganization. In so ruling, the IRS noted that the "regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution."

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129. Rev. Rul. 2003-52, 2003-22 IRB 960.
130. Ltr. Rul. 200323041 (Mar. 11, 2003).
131. Ltr. Rul. 200425033 (Mar. 4, 2004).
132. Ltr. Rul. 200422040 (Feb. 13, 2004).
133. Ltr. Rul. 201219003 (Feb. 3, 2012).
134. Ltr. Rul. 201402002 (Sep. 25, 2013).
135. Rev. Rul. 2003-55, 2003-22 IRB 961.

Observation. It may be advisable to have the various shareholders enter into an agreement providing that any shareholder who violates the post-distribution active trade or business rule agrees to pay **all** taxes incurred by all shareholders if the divisive reorganization fails to pass IRS scrutiny.

Related Function. The IRS does not allow IRC §355 treatment when it believes a transaction is used principally as a device for the distribution of E&P of the distributing corporation, the controlled corporation, or both.[136] Under the regulations, there is evidence of a "device" if a business of either the distributing or controlled corporations (or a downstream subsidiary) is a secondary business that continues as a secondary business for a significant period after separation, and if the secondary business could be sold without adversely affecting the business of the other corporation.[137]

Note. A secondary business is one that either the distributing or controlled corporation operates if its principal function is to serve the business of the other corporation (or a corporation controlled by it). A secondary business can include a business transferred to a newly created subsidiary or a business that serves a business transferred to a newly created subsidiary.[138]

The activities of the secondary business may consist of providing property or performing services. The regulations refer to an example illustrating evidence of a device if the principal function of a coal mine continued after the separation and the coal mine could be sold without adversely affecting the steel business.[139] The regulations also take the position that there would be evidence of a device if the principal function of a sales operation after an IRC §355 separation were to sell the output from the manufacturing operation, and the sales operation could be sold without adversely affecting the manufacturing operation.[140]

Caution. An example of when the IRS might raise the "related function" argument would be the split-up of a farming corporation between the beef cow-calf operation and the dairy heifer feeder/development operation where both resulting corporations receive farmland and equipment in addition to the cows-calves (with pastures) or heifers (with feeding pens, etc.), with further spinning-off of entities owning the equipment, livestock, and inventories. The IRS may take the position that the land cannot be split from the "farming operation." In other words, the IRS could assert that the farming operations are an integral part of the distributing corporation's business such that a spin-off is not allowed because it is a related function.

Capitalization of Reorganization Costs. Courts have regularly held that amounts incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses under IRC §162(a) but rather capital expenditures under IRC §263(a). Thus, costs incurred to facilitate tax-free corporate reorganizations under IRC §368 are generally required to be capitalized.[141]

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136. IRC §355(a)(1)(B) and Treas. Reg. §§1.355-2(d) and (2)(d)(2)(iv)(C).

137. Treas. Reg. §1.355-2(d).

138. Treas. Reg. §1.355-2(d)(2)(iv)(C).

139. Treas. Reg. §1.355-3(c), Example 11.

140. Treas. Reg. §1.355-3(c), Example 10.

141. Treas. Reg. §1.263(a)-5(a)(4).

Ruling Requests. In Rev. Proc. 2003-48, the IRS stated that, for ruling requests after August 8, 2003, it would no longer rule on whether:

1. Distribution of a controlled corporation's stock is carried out for business purposes,
2. The transaction is used principally as a device, or
3. A distribution and an acquisition are part of a plan under IRS §355(e).

In Rev. Proc. 2013-32, the IRS announced a change in its letter ruling policy for the tax-free treatment of corporate spin-offs, reorganizations, and other nonrecognition transactions. For transactions submitted after August 23, 2013, the IRS no longer issues so-called "comfort rulings" on whether transactions qualify for nonrecognition treatment under IRC §355 or on whether transactions constitute a reorganization within the meaning of IRC §368. This is regardless of whether the transaction presents a significant issue or is part of a larger transaction that involves issues upon which the IRS could rule.

However, the IRS further explained that it would rule on one or more issues, under the "nonrecognition provisions," that it determined to be "significant." The IRS defined a "significant issue" as an issue of law, the resolution of which was not essentially free from doubt and that is germane to determining the tax consequences of the transaction. The IRS also decided to restrict its rulings to tax consequences that result from application of the nonrecognition provisions to the extent that a significant issue was presented under a related Code provision that addresses such tax consequences.

More recently, in Rev. Proc. 2016-45,[142] the IRS announced that it would change its "no-rule" position regarding the following issues.

- The corporate business purpose requirement under Treas. Reg. §1.355-2(b)
- Whether a transaction is used principally as a device for the distribution of E&P of the distributing corporation, the controlled corporation, or both under IRC §355(a)(1)(B) and Treas. Reg. §1.355-2(d)

The IRS noted that the policy change was only for significant legal issues and not for issues that are inherently factual in nature.

> **Note.** Before submitting a letter ruling request, the IRS recommends that the taxpayer call the Office of Associate Chief Counsel (Corporate) at (202) 622-7700 to discuss whether the IRS will entertain such a request.[143]

TAX CONSEQUENCES OF CORPORATE LIQUIDATIONS

The liquidation of a corporation is a taxable event, at both the corporation and shareholder levels. The same general rules apply to both C and S corporations, although the tax burden may be quite different due to double taxation on C corporation distributions and single taxation on S corporation distributions.

The remainder of this chapter contains examples showing the tax cost difference between the current liquidation of a C corporation, the current liquidation of an S corporation, and the liquidation of an S corporation following the death of a shareholder.

142. Rev. Proc. 2016-45, 2016-1 IRB 126.

143. See Rev. Proc. 2013-32, 2013-28 IRB 55.

COMPLETE LIQUIDATION OF C CORPORATION

Example 14. XYZ, Inc. has two equal shareholders, John and Ann. The FMV of the corporation's assets (all unimproved real estate on which no depreciation has been taken) is $2 million; the adjusted basis is $1 million. John and Ann each have $200,000 basis in their stock. They would like to liquidate the corporation in 2018 and distribute its assets equally.

John and Ann file as single taxpayers and their corporate distributions are subject to a 23.8% tax rate (20% capital gains rate + 3.8% NIIT) in 2018.

Tax on corporation:	
FMV of assets	$2,000,000
Less: adjusted basis of assets	(1,000,000)
Gain on liquidating distribution (tax at **ordinary** income rates)	$1,000,000
Corporate tax rate	× 21%
Tax on gain	$ 210,000
Distributions to shareholders:	
Corporation's assets (pretax)	$2,000,000
Less: corporate tax liability	(210,000)
Total amount distributed to shareholders	$1,790,000
Number of shareholders	÷ 2
Amount distributed per shareholder	$ 895,000
Less: shareholder basis (each)	(200,000)
Gain recognized per shareholder	$ 695,000
Tax per shareholder at assumed blended rate (Fed: 23.8%; State: 8%)	$ 221,010
Total tax liability:	
Tax on corporation	$ 210,000
Tax on John	221,010
Tax on Ann	221,010
Total tax	$ 652,020

The shareholder's basis of the property received in a liquidation is its FMV at the date of the distribution.[144]

The liquidating corporation recognizes all gains and losses on the distribution of property in liquidation.[145]

- Losses may be limited on recently acquired property if not related to the corporation's business.[146]
- Losses are disallowed for property distributed to the controlling shareholder or a related party, if the property was received as a contribution to capital or received in an IRC §351 exchange within the 5-year period ending on the date of distribution, or if the distribution of loss property is not pro rata.[147]

Shareholders report all gains and losses on the disposition of their shares in an IRC §331 complete liquidation. Different rules apply if a shareholder was a corporation that owned at least 80% of the shares in the liquidated corporation.[148]

144. IRC §334(a).

145. IRC §336.

146. IRC §336(d)(2).

147. IRC §336(d)(1).

148. IRC §§332 and 337.

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 15. Use the same facts as **Example 14,** except XYZ, Inc. has always been an S corporation. Therefore, it is exempt from the BIG tax. If the corporation completely liquidates, no tax is imposed at the corporate level. The shareholders, however, are required to recognize the corporation's gains and losses on the liquidating distribution that passes through to them.

Tax on pass-through gain:		
FMV of assets		$2,000,000
Less: adjusted basis of assets		(1,000,000)
Gain on liquidating distribution		$1,000,000
Gain passed through per shareholder (50%)		500,000
Tax on pass-through gain at assumed blended rate (Fed: 23.8%; State: 8%)		$ 159,000
Distributions to shareholders:		
Corporation's assets (pre-tax)		$2,000,000
Less: amount distributed to each shareholder		(1,000,000)
Basis before liquidating distribution [a]	$200,000	
Add: gain passed through from corporation	500,000	
Shareholder's basis (each)	$700,000	(700,000)
Gain recognized per shareholder		$ 300,000
Tax per shareholder at assumed blended rate (Fed: 23.8%; State: 8%)		$ 95,400
Total tax liability:		
Gain pass-through from corporation ($159,000 × 2)		$ 318,000
Distributions to shareholders ($95,400 × 2)		190,800
Total		$ 508,800

[a] As shown in the next example, if shares are retained until death, a step up to FMV basis generally is obtained. This materially reduces any tax consequences.

4

COMPLETE LIQUIDATION OF S CORPORATION (AT DEATH OF SHAREHOLDER)

The following example illustrates the tax benefits of the retention of stock until the death of a shareholder.

Example 16. ABC, Inc. was incorporated in 1983 as a C corporation. This corporation converted to an S corporation in 1987. ABC, Inc. has one shareholder, Albert, who died in 2017 when the FMV of the corporation's assets was $2 million and the adjusted basis was $1 million (all unimproved real estate on which no depreciation was taken).

Prior to Albert's death, his basis in ABC stock was $0. At his death, Albert's basis in the ABC stock receives a step up to FMV. Therefore, the basis in Albert's ABC stock to his heirs is $2 million. The corporation is liquidated following Albert's death.

Gain passed through from 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:			
Corporation's assets		$2,000,000	
Basis before liquidating distribution [a]	$2,000,000		
Add: gain passed through from corporation	1,000,000		
Shareholder's basis	$3,000,000	(3,000,000)	
Loss recognized (by 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.

Note. 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 occurred in the following year, the capital loss produced upon liquidation would not offset the capital gains 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 is carried forward to subsequent tax years, but does not survive any particular heir's death.