Presentation:

Corporate Taxation
Chapter One: Overview
Professors Wells
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1) Double taxation
2) Tax rates on ordinary income
3) Preferential capital gains rates.
4) Non-recognition for owner-shifts
Since 1909, corporate taxation has existed.

1) Code §11 – corporate tax rate at 21%.

2) Determination of the corporation’s taxable income – no “above the line” vs. “below the line”; why?
   - capital gains & losses (no rate benefit but limits) §1211 & §1212
   - dividends received deduction is available. §243 p.20
   - no passthrough income deduction under §199A.
   - no passive activity loss rules at corporate level

3) Accounting period – is the calendar year required? §441(b) & (i)

4) Accrual method of accounting for most C corporations §448(a) unless personal service corporation or less than $25 million gross receipts (see §448(b)(3) & (c)).
Business Entity Choices

Corporation – “C” or “S” status
Partnership – general or limited
Limited Liability Company (LLC)
Trust or Estate
Sole Proprietorship
Disregarded Entity (DRE)
RICs & REITS and other flow-throughs
Because a corporation is a separate entity, its use create issues:

1. Transfers of property to/from corporations and its shareholders
2. Treatment of interest held by stakeholders in the corporation (debt versus equity)
3. Dividends/profits distributed by corporation to shareholders
4. Redemptions of shares
5. Liquidation of corporation
6. Reorganizations and purchase and sale of corporations or the assets of a corporation. How should these be structured?
Business Tax Reform’s Impact on Choice of Entity

1. Corporate Tax Rate at 21%
2. Individual Tax Rate on QBAI is 29.6% (37% x 80%).
3. Capital Gains Tax at 23.8% (20% + 3.8% surtax under §1411).

Implication:
1. C corporation and dividend create an all-in corporate and shareholder tax cost of 39.8% (i.e., 21% corporate tax + 79% after-corporate tax profits x 23.8%).
2. Basic equivalency between deductible compensation to owners versus dividends (37% plus employment taxes or an all-in 39.8%).
3. Undistributed Business profits earned in a C corporation incur only a 21% tax rate.
4. Business profits of $315,000 earned in a pass-through entity is subject to a maximum individual tax of 29.6% when the owner is subject to the top individual tax rate.
5. Business profits earned in a pass-through entity in excess of $315,000 may be subjected to higher tax rates of up to 37%. Thus, if a business owner cannot accumulate income in a C corporation and does not qualify for the 20% pass-through deduction, then it may not matter what business form is used as the tax cost of these two alternative strategies ranges only between 37% versus 39.8%.
Assume corporate earnings of $100 and Weighted Average Cost of Capital of 12%

**Alternative #1:**  Corporation Distributes All Earnings

<table>
<thead>
<tr>
<th>Corporate Tax (@ 21%)</th>
<th>$21.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Tax (79 * 23.8%)</td>
<td>$18.08</td>
</tr>
<tr>
<td><strong>All-In Tax</strong></td>
<td><strong>$39.08</strong></td>
</tr>
</tbody>
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**Alternative #2:**  Corporation Reinvests all earnings for 7 years

<table>
<thead>
<tr>
<th>Corporate Tax (@21%)</th>
<th>$21.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Tax (79 * 23.8%) x ( \left( \frac{1}{1.12} \right)^7 )</td>
<td>$8.51</td>
</tr>
<tr>
<td><strong>All-In Tax</strong></td>
<td><strong>$29.51</strong></td>
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*Individual tax goes to $1.78 on NPV basis with a 20 year deferral

**Tentative Conclusions:**

1. **Shareholders Who Want Current Cash From the Business:** Alternative #1 shows near parity in double tax result versus a deductible payment taxable at top Individual rate. But, income earned outside corporate context with Section 199A would have had tax rate of 29.6%. Break-even time frame is 7 years between C corporation and flow-through entity. If rate differential is increased, then this increases attractiveness of C corporations.

2. **Shareholders Who Want to Reinvest Earnings Back into the Business:** If business owners expect to reinvest business profits back into their business for longer than 7 years, then conducting the business in C corporation form (and paying the double tax) is less costly on a net present value basis given that ongoing business profits are taxed at only a 28% tax rate and the shareholder 20% capital gains tax plus 3.8% can be deferred. Furthermore, the shareholder tax may be permanently avoided via estate tax planning (§1014) or if small corporate stock (see §1202). Bail-out strategies for shareholder liquidity would be a key ongoing issue.
§7701(a)(3) defines a “corporation” to include associations, joint stock companies, and insurance companies.

Entity under state law could be a state law:

1. Corporation
2. Partnership
3. Limited liability company (LLC)
4. Business trust
5. Some other state law entity.
Prior Entity Classification Criteria – Tax Regs.

1) Associates
2) Business objective
3) Continuity of life
4) Centralization of management
5) Limited liability for debts of entity
6) Free transferability of interests – but buy-sell agreement not limiting transferability.

Regs. had bias *towards partnership* status.
1) Automatic classification of certain entities as corporations – *per se* treatment; including enumerated foreign corporations and an entity that is a state law corporation as well as insurance companies and most banks.

2) If not a per se entity, then the taxpayer can chose the classification. Must file within 75 days of formation.
   a) Can choose corporate status.
   b) Can choose to not be a corporation. If this choice is made, then the entity is a disregarded entity if owned by one owner and a partnership if owned by 2 or more owners.

3) **Default** status of a non *per se* entity is “partnership status” or “disregarded entity status” where no election is made, but again an “eligible entity” may affirmatively elect a contrary status.
1) The “tax nothing” or disregarded entity

2) What tax effect of a change in the number of members of an entity? Can change from partnership status to disregarded entity.

3) Can change election once every 60 month period. What is the effect of an elective change in tax classification of the entity?
   a) Partnership (or DE) to corporation
   b) Corporation to partnership
Corporate treatment of a “publicly traded partnership” where interest are traded on an established securities market. IRC §7704.

What is “publicly traded”? Treas.Reg. § 1.7704–1(b) and (c) provide definitions for an “established securities market” and “readily tradable on a secondary market or the substantial equivalent of a secondary market.”

Exception: partnership status maintained for publicly traded partnership that has 90% or more of its income form “passive sources.” Qualified income for this purpose includes interest, dividends, real property rents, gain from the sale of real property, and income and gains from the exploration, development, extraction, processing, refining, etc., of oil and gas or any other natural resource. See §7704(d)(1)(E).
A. **Per Se Corporations.** Treas.Reg. § 301.7701–2(b)(8) lists certain foreign business entities that are classified as *per se* corporations. Examples of *per se* entities are:

1. Public Limited Company
2. Societe Anonyme
3. Aktiengesellschaft
4. Sociedad Anonima

B. **Elective Classification for all other entities.** Other foreign entities can elect under Treas.Reg. § 301.7701–3(a) whether to be treated as a partnership or as a corporation.

C. **Default Rule for non-*per se* foreign entities:** In contrast to the partnership default classification rules for domestic organizations, the default rule for foreign entities is based on whether the members have limited liability. See Treas.Reg. § 301.7701–3(b)(2),
1. Distinguish between “ordinary trust” the purpose of which is the protection or conservation of trust property **versus** a business trust that is in effect a joint enterprise of the beneficiaries to conduct a business for profit. See Treas.Reg. § 301.7701–4.

   • Outlaw v. United States, 494 F.2d 1376 (Ct.Cl.1974) a trust was formed to own and manage some 10,000 acres of farm land and employed 18 to 20 full-time and 60 to 70 temporary workers to engage in a full scale agricultural operation. Trust classified as a business entity taxable as a corporation.

   • Rev.Rul. 80–75, 1980–1 C.B. 314 (trust established by promoter to conduct business activity classified as a business association)

2. Liquidating Trusts. Treas.Reg. § 301.7701–4(d) provides that as long as the primary purpose of the trust is the liquidation and distribution of the assets then the trust will not be an association taxable as a corporation.
1. Regulated investment companies (RICs) investing in securities (mutual funds including exchange traded funds) are in effect relieved of corporate tax liability with respect to the dividends and capital gains from their stock investments if they currently distribute this income to their shareholders. A mutual fund to this extent is thus treated as a conduit rather than a taxable entity. See I.R.C. §§ 851–855.

2. Congress extended conduit treatment to real estate investment trusts (REITs) otherwise taxable as corporations (see §§ 856–860).

3. Congress further extended conduit treatment to real estate mortgage investment conduits (REMICs) (§§ 860A–860G).
1. Anne and Bill plan to form a limited liability company to engage in the business of developing and marketing computer software. Only Anne and Bill will have authority to act on behalf of the LLC. Because of the limited powers that the investor-members will be granted, Anne and Bill think it best that the investors be permitted to sell or assign their membership interests if they so desire. Of course, Anne and Bill want the business of the LLC to be uninterrupted by the death, bankruptcy, etc., of an investor-member.

Question: Will the LLC be taxed as a corporation if organized in the manner contemplated by Anne and Bill?
2. (a) Rabbit Battery Manufacturing Corp. formed two wholly owned limited liability companies Cadmium Disposal LLC and Mercury Recycling LLC.

Question: What is the effect, if any, on Rabbit’s taxable income if Cadmium Disposal has net losses of $2,000,000 this year and Mercury Recycling has net income of $3,000,000.
2. (b) Rabbit Battery Manufacturing Corp. has a wholly owned subsidiary, Cadmium Disposal, Inc. Rabbit owns 8 of 10 membership units in Mercury Recycling LLC, a limited liability company, in which Cadmium Disposal owns the other 2 membership units.

Question: What is the effect, if any, on Rabbit’s taxable income if Cadmium Disposal has net losses of $2,000,000 this year and Mercury Recycling has net income of $3,000,000?
FACTS: Corporation holding title to real property to avoid state usury laws.

Issue: Does the corporation have the NOLs or was it merely the “agent” of the partnership so that partnership has NOLs?

Holding: Corporation’s purpose and activities sufficient to require recognition.

1) Moline Properties v. Commissioner, 319 U.S. 436 (1943) (so long as the corporation’s purpose is the equivalent of business activity or is followed by the carrying on of business, the corporation is a separate taxable entity.)

2) National Carbide Corp. v. Commissioner, 336 U.S. 422, 433–434 (1949) (The Supreme Court has held that shareholder domination is insufficient to permit taxpayers to ignore the corporation’s existence).
FACTS: Corporation holding title to real property.

Issue: Is the corporation the earner of the income or is it merely the shareholder’s “agent”?

Holding: Agency status permitted &, therefore, losses were directly allowable to the individual investors as individuals – (also being shareholders of the corporate agency).

National Carbide Factors

1) Corporation operates in the name and for the account of the principal;
2) Corporation binds the principal;
3) Transmits money to the principal;
4) Income attributable to services of the employees of the principal:
5) Relations with the principal must not be dependent upon the fact that it is owned by the principal; (See Bollinger case discussion) and,
6) Business purpose must be the carrying on of the normal duties of an agent.
Greenberg v. Commissioner, 62 T.C. 331 (1974), aff’d per curiam, 526 F.2d 588 (4th Cir. 1975), two individuals formed five corporations to develop large residential subdivisions. All corporations performed identical functions. The court held that the four liquidated corporations were merely shams; all the income earned by those corporations was the income of the continuing corporation. “These [liquidated] corporations served no purpose except to obtain a tax benefit.”

Robucci v. Commissioner, T.C. Memo 2011–19, the Tax Court disregarded the entity status of two corporations formed by a practicing psychiatrist because the corporation “was not formed for a purpose that ‘is the equivalent of a business activity’ within the meaning of Moline Props., Inc. v. Commissioner, 319 U.S. at 429.”

Noonan v. Commissioner, 52 T.C. 907 (1969), aff’d per curiam, 451 F.2d 992 (9th Cir. 1971), a corporation received income as a limited partner from a business enterprise in which the sole shareholder was a general partner. The Tax Court acknowledged that the corporation had been properly organized, but it refused to recognize the separate corporate entity where the record was devoid of evidence showing any active business purpose.
Weekend Warrior Trailers, Inc. v. Commissioner, T.C. Memo. 2011–105, manufactured travel trailers, established a sibling corporation, Leading Edge, to provide design and management services, to be performed by the taxpayer’s shareholder as an employee of Leading Edge (while he also continued to serve as a managerial employee of the taxpayer), for the taxpayer’s manufacturing operations. The taxpayer also transferred its employees to Leading Edge, which then leased the employees to Weekend Warrior Trailers, Inc. Tax Court stated that corporation “must be respected for tax purposes if it actually engaged in business activity” and then stated it was not a “lifeless façade.”

Siegel v. Commissioner, 45 T.C. 566 (1966) (Acq.), the taxpayer, wishing to limit his potential liability, established a Panamanian corporation to invest in a farm joint venture in Cuba. The sole activity was “investment.” The Tax Court concluded that there was a sufficient amount of business activity: “Nor may it be said that [the corporation’s] minimal activity did not constitute the conduct of business. The point is that [the corporation] was formed for only a limited purpose, namely, to invest in the joint venture.” The court then said that this was sufficient business activity for the corporation to be respected.

Bass v. Commissioner, 50 T.C. 595 (1968), The IRS attempted to discount the business actions of the corporation on the theory that the taxpayer “actually made the business decisions for the corporation.” The Tax Court concluded that the corporation was a viable business entity since it had “acted” like a genuine corporation. “The fact that the owner retains direction of its affairs down to the minutest detail [makes] no difference tax-wise.”
Heaton v. Commissioner, T.C. Memo. 1989–459, held that under Bollinger the absence of a written agency agreement was fatal to the taxpayer’s agency claim, but the court also examined other factors to support its conclusion that the taxpayer failed to satisfy the Bollinger standards.

Greenberg v. Commissioner, T.C. Memo. 1989–12. The importance of upfront agreements and formal compliance with agency relationship prevented taxpayer from disregarding corporation’s ownership.

In re LeBlanc, 79 A.F.T.R.2d 97–754 (Bkrtcy.E.D.La.1997), held that Bollinger did not merely establish a safe harbor but established a definite standard, although less stringent than the National Carbide test, that must be met for a genuine agency relationship to exist. According to the LeBlanc court, the tripartite Bollinger test requires: “(1) ‘the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired’; (2) ‘the corporation functions as agent . . . with respect to the asset for all purposes’; and (3) ‘the corporation is held out as the agent . . . in all dealings with third parties relating to the asset.’”
Donald Dudley and Webster Dudley are local real estate developers.

(a) A corporation might obtain the land and some period of time may elapse between the acquisition and the commencement of construction. To minimize carrying costs, after the acquisition but prior to transferring title of the land to Dudley Brothers Construction Company upon commencement of construction, the corporation will lease out the vacant land. For example, rural land may be rented out for farming and city land may be rented out to another company to run a parking lot. The nominee corporation would simply receive rents, deposit checks to a bank account, and immediately pay the rent over to Dudley Brothers Construction Company using its own checks.

Question: Will the activities be taxed to the corporations or will the corporation be ignored for tax purposes?
Donald Dudley and Webster Dudley are local real estate developers.

(b) One or more of the corporations would acquire fee simple title and/or options on the land in its own name, and upon completing the acquisition would immediately transfer title to the land and/or the options to the partnership.

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Section 482 authorizes the IRS to reallocate items of income, deduction, or credit among two or more organizations, trades or businesses under common control when necessary to prevent evasion of taxes or clearly to reflect income.

**Borge v. Commissioner**

**Facts:** Danica, a corporation owned by Victor Borge, conducted a poultry business that was transferred to it from Victor Borge and incurred substantial losses. Victor Borge agreed to provide entertainment services for Danica for 5 years and was paid a reduced fee. IRS allocated income from Danica to Victor Borge.

**Holding:** Lower court found that the entertainment business was conducted by Borge, not Danica, and therefore the income from that business was properly allocable to Borge.
1. Most §482 cases in the domestic context deal with shareholder owning property that is leased to a corporation and the amount of the rent is either excessive or below-market. If income relates to the income-producing asset, then §482 is straightforward in allocating the income generated by that asset to the asset’s owner.

2. Formal Control Not Necessary if in fact a control relationship exists. See Hall v. Commissioner, 32 T.C. 390 (1959) (Acq.), aff’d, 294 F.2d 82 (5th Cir. 1961), (The Tax Court said that § 482 was applicable regardless of the legal ownership of the stock since the taxpayer in fact exercised control over the corporation and dominated it.)

3. Shareholder-Employee. Shareholder’s employment income must be reasonable. Tax Court believes §482 applicable in that context but Seventh Circuit in Foglesong v. Commissioner did not believe §482 can be applied as the shareholder employee is not a “second organization.” IRS in Rev.Rul. 88–38, 1988–1 C.B. 246 stated that it disagrees with Foglesong.
1. If corporation does not have “control over the income,” then assignment of income is a second argument.

Johnson v. Commissioner, 78 T.C. 882 (1982), aff’d by order, 734 F.2d 20 (9th Cir. 1984):
   (i) The service-performer employee must be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense.
   (ii) The services contract must evidence the corporation’s controlling position.

When only NBA contract was between the player and the team, the income properly assigned to player.

2. Haag v. Commissioner, 88 T.C. 604 (1987) (the corporation was treated as controlling the income, because the individual and corporation entered into an employment contract and the recipients of services treated the services as being rendered by the corporation, but §482 could apply to ensure that physician-sole shareholder’s salary was reasonable).
Targeted provision for personal service corporations that authorizes reallocation of income from a personal service corporation to the employee-owner if:

1. The **principal purpose** for using the corporation is the avoidance of federal income tax by reducing the income of any employee-owner.
2. Corporation **performs substantially all** of its services **on behalf of one other corporation, person, or partnership**; and
3. Substantially all of the services provided by the corporation are performed by employees who own more than 10% of the stock.

Georgia, an individual, owns all of the stock of Malific Xenophobe Oil Distributing Corporation, which not only has not shown a profit, but has consistently lost money in every year since Georgia acquired the stock. Georgia also conducted an oil and gas equipment leasing business as a sole proprietor. Georgia’s largest drilling rig normally leases for $1,000 a day. Recently Malific Xenophobe used Georgia’s drilling rig for 60 days, and because Malific Xenophobe’s reserves and credit were insufficient to permit it both to pay its workers and pay Georgia $60,000, Georgia rented the drilling rig to Malific Xenophobe for the 60 days for $5,000.

Question: What are the tax consequences to Georgia and Malific Xenophobe?
Non-codified federal income tax rules (particularly relevant in the corporate income tax context):

1) The “sham transaction” rule.
2) “Substance over form” analysis.
3) The “business purpose” doctrine.
4) The “step transaction” doctrine.
5) Codified §7701(o) – re: economic substance
1. **Formulation of the Step Transaction Doctrine:** “A given result at the end of a straight path is not made a different result because reached by following a devious path.” Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

2. **Application of the Doctrine:** When applied, the tax treatment of several transactions is determined by examining their **overall effect rather than giving effect to each of the several transactions** in sequence.

3. **Standard of Application:**
   a) **Binding Commitment Test:** Step Transaction Doctrine applied if at the time the first step is entered into there was a binding commitment to undertake the later step.
   b) **Mutual Interdependence Test:** Step Transaction Doctrine applied if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.
   c) **End Result Test:** Step Transaction Doctrine applied if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. The end result test is based upon the actual intent of the parties as of the time of the first step.

4. **Resequeencing:** As a general matter, the Step Transaction Doctrine is not applied to simply resequence steps. See *Esmark*.