Corporate Taxation

University of Leiden –
International Tax Center
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Professor William P. Streng
University of Houston Law Center

Relevance of this Corporate Taxation Course

Federal income tax planning concerns include:
1. Choice of business enterprise form
2. Capital structure of the enterprise, e.g., debt or equity (or both)
3. Dividend policy
4. Compensation policy
5. Estate planning
BUSINESS ENTITY CHOICES

Corporation
   “C” or “S” corporate tax status
Partnership - General or limited
Limited Liability Company (LLC)
Trust or Estate (available?)
Sole Proprietorship
Disregarded Entity (DRE)

Corporation/Shareholder Tax Policy Issues

1) Double taxation, i.e., at corporate and shareholder level; but, 2003 Act.
2) Tax rates on ordinary income - corporation and shareholder;
   Equalized after the 2003 Act?
3) Preferential capital gains rates.
4) Non-recognition upon asset/ownership shifts.
Fundamental Corporate Tax Technical Issues

1. Contributions to the corporation - gain recognition to either party?
2. Arrangements between owners & entity – i.e., "assignment of income" permitted?
3. Distributions of appreciated property.
4. Corporate liquidations, including sales in conjunction with a corporate liquidation.
5. Corporate reorganizations - possible postponement of gain recognition.

“Cradle to Grave” Approach in this Course

1. What is a “corporation”?
2. Organization - §351 Note: Code § 61.
3. Tax on corporate income? Entity level tax or flow-through?
4. Capital structure - Debt vs. equity Is interest expense deduction available? Tax-free repatriation of debt?
5. Dividends – tax treatment? continued
“Cradle to Grave”, cont.

6. Significant interim distributions:
   Redemptions & partial liquidations
   Stock dividends
   §306 stock (indirect dividend?)

7. Terminating stock ownership interest

8. Taxable complete or partial liquidation

9. Corporate tax-free reorganizations

Concepts of “Tax Common Law”

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.
Federal Income Taxation of the Corporation

1) Code §11- graduated tax rate structure.
   - Code §11(b)(1) - no lower initial brackets for personal service companies.
2) Determination of the corporation’s taxable income –
   no “above the line” vs. “below the line”;
   - dividends received deduction is available.
   - Deduction for domestic production - §199.
3) Accounting period – is the calendar year required?

Income Taxation of the Corporation, cont.

5) Code §267 – limitations on transactions between corp. & owners, i.e., potential “gaps.”
6) Corporate Alternative Minimum Tax repealed for small corporations.
7) Multiple corporations - § 1561
   Consolidated tax returns for an affiliated group of corporations - §§ 1501-1504.
8) The “S” corporation alternative.
## Example

(a) Determining corporate level gross income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory sales</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital gains</td>
<td>200,000</td>
</tr>
</tbody>
</table>

2,800,000

Exclusion under §103 for muni-bond interest

### Deductions Against GI

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>600,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>800,000</td>
</tr>
<tr>
<td>Passive leasing activity loss</td>
<td>130,000</td>
</tr>
<tr>
<td>§469(a)(2)(B) &amp; §469(e)(2)</td>
<td></td>
</tr>
<tr>
<td>Capital loss (limit to gain)</td>
<td>200,000</td>
</tr>
<tr>
<td>Dividends received deduction</td>
<td>70,000</td>
</tr>
<tr>
<td>Total deductions</td>
<td>1,800,000</td>
</tr>
</tbody>
</table>

continued
Determining Tax Liability

§11(b)(1) tax calculation on $1 million taxable income:

15% of 50,000 = 7,500
25% of 25,000 = 6,250
34% of 925,000 = 314,500

Plus: lesser of $45,000
(5% of 900,000) or 11,750 = 11,750

Total: 340,000

Dividend distribution

Distribution of $660,000 after-tax profit

§61(a)(7) dividend income

20 percent of $660,000 = $132,000
Total taxes: (340 + 132) = $472,000
Amount for shareholders: $528,000
Effective tax rate: 47.2 percent
(is a 47.2% effective tax rate too much?)
**Deductible (?) payments**

1) $500,000 salaries paid - to eliminate all corporate level income. Reasonable compensation?
2) Other corporate level deductions available for this purpose? §79 - group term insurance §105 & 106 - health benefits

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**Corporate Tax Shelters**

Concept of “tax sheltering”- claiming tax losses without economic losses, including questionable economic substance. Possible use of “tax indifferent” parties. Aggressive marketing, coupled with secrecy. Tax opinions which are aggressive. Playing the “audit lottery”. Note applicability of “Circular 230.”
Attempts to Limit Corporate Tax Shelters

1) IRS litigation strategy.
2) Disclosure of tax shelter investments, including registration of tax shelters.
3) Increased “substantial understatement” penalty.
4) Excise tax on promoter’s fees.

UPS case

UPS organized an offshore subsidiary (OPL) to provide reinsurance for excess value insurance on shipments.

OPL shares distributed to UPS shareholders. Issue re income for excess value net amount realized by OPL or UPS?

Economic substance to this arrangement?

Held: Not a sham transaction; adequate business purpose; but § 482 applicable?
Corporation/Shareholder Tax System Integration

U.S. has a **classical** tax system - taxation both on the corporation and the shareholder.

Who pays the corporate tax:

- the corporation or the shareholders?

The **full integration** option: complete flow-through, e.g., the ALI proposal of:

1. **imputation** and (2) **withholding** (for U.S. Treasury cash flow).

Partial corporate shareholder integration

1. Shareholder **credit** for tax previously paid on the dividend amount - subject to an income gross-up requirement.

2. Shareholder gross income **exclusion** for all or part of corporate dividend.

   - 2003 Act - reduce individual dividend tax to 15% (extended through 2009)

3. **Deduction** available to the distributing corporation for the dividend paid.
Special concerns about integration proposals

1. Extension of corporate tax preferences to shareholders.
2. Treatment of tax-exempt shareholders (e.g. deferred compensation plans).
3. Treatment of foreign shareholders (only through tax treaty?) - 30% under 2003 Act.
4. Treatment of foreign taxes paid by the U.S. corporation.