SUMMER 2014

STUDENT UPDATE MEMORANDUM

FUNDAMENTALS

OF

CORPORATE TAXATION

Eighth Edition

By

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With the Collaboration of

BRANT J. HELLWIG

PREFACE

This Summer 2014 Student Update Memorandum brings *Fundamentals of Corporate Taxation* up to date by summarizing major developments that have occurred since publication of the Eighth Edition in July of 2012. The most important federal tax development during the past two years was the enactment of the American Taxpayer Relief Act of 2012, averting a plunge from the fiscal cliff and making the individual income tax rates permanent for the first time in a decade, at least until Congress decides to change them again in the future. Other developments included the issuance of various final and proposed regulations and a continuing but as yet unresolved conversation about corporate tax reform.

Instructors who have adopted the text may distribute paper or electronic copies of the Update Memorandum to their students.

The Update Memorandum is organized to parallel the text, with cross references to chapter headings and page numbers. It covers developments through July 15, 2014.

We are pleased to welcome Professor Brant Hellwig of Washington and Lee University School of Law and thank him for his contributions to this year's update. We look forward to his participation as a co-author on future editions.

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San Francisco, California
July 2014

PART ONE: INTRODUCTION

CHAPTER 1. AN OVERVIEW OF THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

A. INTRODUCTION

1. TAXATION OF BUSINESS ENTITIES

Page 8:

After the carryover paragraph, insert:

For the first time in many years, the individual income tax rates are no longer in flux – at least for now. Beginning in 2013, the American Taxpayer Relief Act of 2012 ("ATRA") made permanent what had become known as "the Bush tax cuts" – i.e., lower tax rates on ordinary income and capital gains for most individuals – except, as part of a political compromise, "high income" taxpayers are taxed at a marginal rate of 39.6 percent on income over various thresholds, which are indexed annually and in 2014 are: $457,600 for married filing jointly, $406,750 for unmarried, $432,200 for head of household, and $228,800 for married filing separately. Congress also finally provided for indexing of the alternative minimum tax, obviating the need for an annual exemption "patch" to prevent more middle class taxpayers from being subject to the AMT.

ATRA made permanent the zero and 15 percent rates for most long-term capital gains and qualified dividends but raised the top rate to 20 percent for high income taxpayers. The 20 percent rate, however, applies only to the extent that these tax-favored items otherwise would fall into the 39.6 percent marginal bracket if they were ordinary income. The 28 and 25 percent rates for collectibles and unrecaptured Section 1250 gain remain unchanged.

Congress also restored the reduction of itemized deductions in Section 68 and the phase-out of personal exemptions in Section 151(d)(3) for high income taxpayers. The effect of both these stealth tax increases is to impose a higher marginal rate on taxpayers whose adjusted gross income exceeds applicable threshold amounts, which in 2014 are: $305,050 for married filing jointly taxpayers, $254,200 for single filers, $279,650 for heads of household, and $152,525 for married filing separately. These thresholds, which are different from those used as the starting point for the 39.6 percent marginal bracket, also will be indexed annually for inflation.

Page 10:

After the third full paragraph, insert:

The question – what of the future? – as it relates to the corporate income tax continues to be discussed throughout the tax policy universe but the future remains as uncertain as it has been for many years. For a brief update on the corporate tax reform conversation, see *infra* pp. 2-3 of this Update Memorandum.

B. THE CORPORATION AS A SEPARATE TAXABLE ENTITY

4. THE S CORPORATION ALTERNATIVE

Page 25:

At the end of the third full paragraph, insert:

For 2014, the Social Security tax wage base increased to $117,000 and, with the expiration of the two percent "tax holiday" on the employee's share at the end of 2012, the tax rate for both employers and employees is back to 6.2 percent each. For self employed taxpayers, the Social Security tax portion of self-employment tax is back up to 12.4 percent. As previewed in the text (footnotes 20 and 21), the Medicare tax rate increased to 3.8 percent in 2013 for taxpayers with wages or self-employment income above these thresholds: $250,000 married filing jointly, $200,000 single and head of household, and $125,000 married filing separately.

E. TAX POLICY ISSUES

2. OTHER CORPORATE TAX REFORM OPTIONS

Page 53:

After the second full paragraph, insert:

A muted conversation about comprehensive tax reform took place during the 2012 Presidential campaign, with both candidates supporting rate reductions to the corporate income tax but neither offering much specificity on what "loopholes and subsidies" to eliminate. Since then, a meandering discussion comes and goes in Congress, as both the House Ways and Means and Senate Finance Committees deliberate over issues and options. The taxation of business entities is a major topic in the debate.

In March 2013, House Ways and Means Committee chair Dave Camp (R-Mich.) released a provocative discussion draft of small business tax reform proposals. Two major options were floated. The first would essentially retain the structure of the present system, leaving Subchapter C intact but make several significant changes to the taxation of partnerships, LLCs and S corporations. The more radical second option would eliminate Subchapters K and S and replace them with a single unified pass-through regime that supposedly would simplify tax compliance for many small businesses but also would limit flexibility for partnerships and limited liability companies. A summary of Representative Camp's proposal is available at http://waysandmeans.house.gov/uploadedfiles/small_biz_summary_description_03_12_13_final.pdf.

In June 2013, the Senate Finance Committee staff issued a bipartisan option paper on taxation of business income and entities. Three goals for tax reform were articulated: simplification, neutrality (reducing differences in tax burdens across different types of entities, income and owners), and reduction or elimination in the different tax treatment of debt and equity. The paper summarizes without commentary a non-exhaustive list of competing reform proposals advanced by a variety of legislators, academics and think tanks over the past 30 or so years. It is more a "laundry list" than a specific agenda for reform. See Types of Income and Business Entities, Senate Finance Committee Reform Options for Discussion (June 6, 2013), available at http://www.finance.senate.gov/issue/?id=0fb586fb-ba29-46ea-a194-df488e41b1bd.

In early 2014, Ways and Means Committee chair Camp released draft legislation with the stated goals of strengthening the economy and making the tax code simpler, fairer and flatter. Chairman Camp's ambitious bill includes extensive business tax reforms, including repeal of numerous business-related exclusions, deductions and credits; repeal of the alternative minimum tax; reduction of corporate tax rates; and a long list of micro and macro changes to the tax treatment of pass-through entities. See Joint Committee on Taxation, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III–Business Tax Reform (JCX-14-14, Feb. 26, 2014), available at https://www.jct.gov/publications.html?func=startdown&id=4556.

Despite all this hard work, a consensus on the need for and shape of comprehensive tax reform has not yet emerged, and prospects for serious reform are slim to none in the current gridlocked political environment. The most likely scenario is that the talk will continue, with competing narratives, through the 2014 Congressional elections. The future direction of tax reform, if any, will be influenced by the composition of the next Congress and may continue to remain uncertain until after the 2016 Presidential election.

PART TWO: TAXATION OF C CORPORATIONS

CHAPTER 2. FORMATION OF A CORPORATION

A. INTRODUCTION TO SECTION 351

Page 59:

After the first full paragraph, insert:

In 2013, the Service issued final regulations interpreting the limitations on duplication of built-in losses under Section 362(e)(2).[7.1] The final regulations make no significant substantive changes to the proposed regulations issued in 2006 but they employ a different organizational structure, introduce some new terminology, and clarify the application of Section 362(e)(2) to specialized transactions.

At the end of footnote 12, remove the citations to the proposed regulations and insert:

Reg. § 1.362-4(g)(1)(ii); Prop. Reg. § 1.362-3(b)(3). In 2013, the Service issued proposed regulations to help identify transactions subject to the anti-importation rule in Section 362(e)(1) and elaborate on the operation of the rule. REG-161948-05 (Oct. 28, 2013), 2013-44 I.R.B. 449, publishing Prop. Reg. § 1.358-6, 1.362-3.

Pages 59-60:

Remove the citations to the proposed regulations in footnotes 9-11, 13, and 15 and replace them with the following citations to the final regulations:

Fn. 9. Reg. § 1.362-4(b).

Fn. 10. Reg. § 1.362-4(g)(3), -4(h) Example 1.

Fn. 11. Reg. § 1.362-4(h) Example 6.

Fn. 13. Reg. § 1.362-4(g)(5).

Fn. 15. Reg. § 1.362-4(d)(2).

[7.1] T.D. 9633, 2013-39 I.R.B. 227.

Chapter 3. Capital Structure

D. Character of Gain or Loss on Corporate Investment

Page 144:

At the end of footnote 4, insert:

In the American Recovery and Reinvestment Act of 2009, Congress increased the percentage exclusion under Section 1202 for qualified small business stock ("QSBS") sold by an individual from 50 to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011. In the Small Business Jobs Act of 2010, Congress enacted a more generous temporary amendment permitting the exclusion of 100 percent of the gain from the sale of QSBS acquired after September 27, 2010 and before January 1, 2011, provided the stock was held for more than five years and certain other requirements were met. Under this provision, the exclusion applied for purposes of both the regular and alternative minimum taxes. The Tax Relief Act of 2010 extended the 100 percent exclusion and AMT exemption for stock acquired after December 31, 2010 and before January 1, 2012, and the American Tax Relief Act of 2012 granted a further extension to eligible stock acquired after September 27, 2010 and before January 1, 2012. The Obama Administration continues to propose making the 100 percent exclusion and AMT preference item exemption for excluded gains permanent.

Chapter 4. Nonliquidating Distributions

A. Introduction

2. Qualified Dividends

Pages 153:

After the carryover paragraph, insert:

One of the more significant compromises in the fiscal cliff showdown was the decision to continue taxing qualified dividends at preferential long-term capital gains rates. This tax preference for dividends was made permanent and now appears to have gained sufficient traction to become a permanent feature of the taxation of corporations and shareholders. The lower tax rates on qualified dividends and long-term capital gains, which were scheduled to sunset for tax years beginning after December 31, 2012, also were made permanent for "middle class" taxpayers but the top rate was raised to 20 percent for high income taxpayers (using the same thresholds used for purposes of the 39.6 percent marginal rate on ordinary income).

Chapter 5. Redemptions and Partial Liquidations

A. Introduction

Page 198:

At the end of the carryover paragraph, insert:

Although the top rate for long-term capital gains and qualified dividends was raised to 20 percent in 2013 for high-income taxpayers (23.8 percent after taking into account the net investment income tax), the analysis of the tax stakes on a redemption remains unchanged – i.e., the stakes still are much lower than when dividends were taxed at ordinary income rates.

B. CONSTRUCTIVE OWNERSHIP OF STOCK

Page 199:

At the end of the first full paragraph, insert:

With the Supreme Court's decision declaring the Defense of Marriage Act unconstitutional, a same-sex spouse in a marriage valid under state law (but not a registered domestic partner) will be considered a "spouse" for purposes of the Section 318 attribution rules and other family attribution rules scattered throughout the Code.

CHAPTER 6. STOCK DIVIDENDS AND SECTION 306 STOCK

C. SECTION 306 STOCK

1. THE PREFERRED STOCK BAILOUT

Page 305:

After the third full paragraph, insert:

Now that taxation of qualified dividends and long-term capital gains at the same preferred rates is a permanent feature of the Code, we can say with more certainty that the advantages of bailing out corporate earnings at capital gains rates are considerably if not completely eliminated. But if past history is any guide, Congress will not remove Section 306 from the Code just yet because of the chance that the pendulum may shift back in the future.

CHAPTER 7. COMPLETE LIQUIDATIONS

C. LIQUIDATION OF A SUBSIDIARY

1. CONSEQUENCES TO THE SHAREHOLDERS

Page 336:

At the end of footnote 1, insert:

In September, 2013, the Service issued proposed regulations clarifying the application of the anti-loss importation rule in Section 334(b)(1)(B). See REG-161948-05 (Oct. 28, 2013), 2013-44 I.R.B. 449, publishing Prop. Reg. § 1.334-1.

CHAPTER 8. TAXABLE CORPORATE ACQUISITIONS

C. STOCK ACQUISITIONS

4. SECTION 336(E)

Page 371:

After the third full paragraph, insert:

As discussed in the text, Section 336(e) was enacted as part of the Tax Reform Act of 1986, but taxpayers were not allowed to make a Section 336(e) election until the promulgation of final regulations. In May 2013, a mere 27 years after the enactment of Section 336(e), the gates finally opened with the issuance of final regulations that apply to any "qualified stock disposition" for which the disposition date is on or after May 15, 2013.[9] Like the proposed version released in 2008, the final regulations permit a corporation with "control" (80 percent of vote and value) of another corporation ("T") to make an election under Section 336(e) to treat certain sales, exchanges, and distributions of T stock as taxable sales of T's assets, and they provide guidance on the scope of Section 336(e), its relationship to Section 338(h)(10), and the requirements for and mechanics of a Section 336(e) election.

The general design of the final regulations is similar to the proposed regulations. Two major changes were made, both of which make the Section 336(e) election more user friendly in particular transactional fact patterns. First, the final regulations permit a Section 336(e) election to be made when an S corporation is the target, as has long been permitted for Section 338(h)(10) elections.[10] In that situation, all the S corporation's shareholders, even those who are not selling their stock, must consent to the election. Second, the final regulations relax the loss disallowance rule for certain distributions of target stock. The Service defended the strict loss limitation rule in the proposed regulations by pointing to the need to be consistent with the strict limitation on recognition of losses imposed by Section 311(a) for nonliquidating distributions. On reflection, it concluded that a less rigid approach was appropriate. The final regulations generally permit the target corporation to use losses on the deemed sale of its assets to offset realized gains triggered by a Section 336(e) election.[11] As a result, only the target's net loss on the deemed asset sale is permanently disallowed and only in proportion to the portion of the target stock that was disposed of by the seller in one or more distributions during the 12-month disposition period, whether or not the distribution was part of a qualified stock disposition.[12]

Another change relates to the manner in which a Section 336(e) election is made. The proposed regulations permitted the seller to make a unilateral election. The final regulations provide that a Section 336(e) election will not be effective unless the seller and the target (acting as a proxy for the purchasers) enter into a written binding agreement to make the election and both

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[9]T.D. 9619, 2013-24 I.R.B. 1212.

[10]Reg. § 1.336-1(b)(3).

[11]Reg. § 1.336-2(b)(1)(i)(B)(2)(i).

[12]Reg. § 1.336-2(b)(2)(iii).

the seller and target corporations attach Section 336(e) election statements to their tax returns.[13]

And there is lots more, including a relaxation of the definition of "related party" as it applies to partnerships.[14] The related party concept can be relevant to whether a transaction is a qualified stock disposition because stock disposed of to a "related party" does not count in meeting the 80 percent threshold. The final regulations include numerous detailed examples (none are light reading).[15]

CHAPTER 9. ACQUISITIVE REORGANIZATIONS

A. INTRODUCTION

2. OVERVIEW OF REORGANIZATIONS

Page 396:

At the end of footnote 13, insert:

In Rev. Proc. 2013-32, 2013-28 I.R.B. 55, the Service announced that, to conserve its resources, it no longer would issue letter rulings on whether a transaction constitutes a reorganization under Section 368 "regardless of whether the transaction presents a significant issue" or is "an integral part of a larger transaction that involves other issues upon which the Service will rule." Id. at § 4.01(1). The Service will continue to rule on one or more issues (as distinguished from the entire transaction) if they are "significant." Id. The definition of "significant issue" was changed by eliminating the requirement that the issue must not be clearly and adequately addressed by a statute, regulation, or other authority. "Significant issue" is now defined as "an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction." Id. at § 4.01(3). This continues a trend of scaling back what are known as "comfort rulings" that historically were requested by corporate tax advisors in advance of a transaction to assure certain favorable tax consequences but gradually have been replaced by opinions of counsel.

C. TREATMENT OF THE PARTIES TO AN ACQUISITIVE REORGANIZATION

Page 439:

In the second line from the bottom of the page, delete "ignore."

3. CONSEQUENCES TO THE ACQUIRING CORPORATION

Page 448:

At the end of footnote 6, insert:

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[13] Reg. § 1.336-2(h).

[14] See Reg. § 1.336-1(b)(12).

[15] See, e.g., Reg. § 1.336-2(k).

In 2013, the Service issued proposed regulations to help identify property and transactions subject to the anti-importation rule in Section 362(e)(1) and elaborate on the operation of the rule. REG-161948-05 (Oct. 28,2013), 2013-44 I.R.B. 449, publishing Prop. Reg. § 1.358-6, 1.362-3.

CHAPTER 10. CORPORATE DIVISIONS

C. JUDICIAL AND STATUTORY LIMITATIONS

1. BUSINESS PURPOSE

Page 487:

After the carryover paragraph, insert:

In Rev. Proc. 2013-32, 2013-28 I.R.B. 55, the IRS announced that it would no longer issue advance rulings on the tax-free status of corporate divisions but will continue to rule on one or more "significant issues" presented in a Section 355 transaction but not on the transaction as a whole.

CHAPTER 11. NONACQUISITIVE, NONDIVISIVE REORGANIZATIONS

B. NONDIVISIVE TYPE D REORGANIZATIONS

Page 541:

In the first line of Problem 2, B is A's (not T's) son.

CHAPTER 12. CARRYOVERS OF CORPORATE TAX ATTRIBUTES

B. SECTION 381 CARRYOVER RULES

Page 554:

At the end of the carryover paragraph, insert:

Historically, it has been unclear which corporation succeeds to the tax attributes of the target corporation in a tax-free asset acquisition, such as a Type C reorganization, where the acquiring corporation transfers all or part of the target's assets to one or more controlled subsidiaries. Proposed regulations issued in 2012 provide that only a single "acquiring corporation" may succeed to the target's earnings and profits.[3.1] Those E & P remain with the acquiring corporation unless all the acquired assets are transferred to a single subsidiary, in which case the subsidiary succeeds to the E & P. Proposed regulations issued in 2014 adopt a stricter but simpler approach

[3.1] REG-141268-11 (May 7, 2012), 2012-19 I.R.B. 896, publishing Prop. Reg. § 1.312-11(a).

with respect to all tax attributes governed by Section 381, not just E & P.[3.2] They provide that, for purposes of Section 381(a)(2), the "acquiring corporation" is the corporation that directly acquires the transferred assets even if it ultimately retains none of them assets – for example, because it dropped down part or even all of the assets to a controlled subsidiary.[3.3]

CHAPTER 14. ANTI-AVOIDANCE RULES

C. THE ACCUMULATED EARNINGS TAX

2. THE PROSCRIBED TAX AVOIDANCE PURPOSE

Page 627:

At the end of footnote 2, insert:

Effective for tax years beginning after December 31, 2012, the accumulated earnings tax rate was increased from 15 to 20 percent by the American Taxpayer Relief Act of 2012.

D. THE PERSONAL HOLDING COMPANY TAX

1. INTRODUCTION

Page 646:

After the first sentence of the first full paragraph (after the indented text), insert:

Effective for tax years beginning after December 31, 2012, the personal holding company tax rate was increased from 15 to 20 percent by the American Taxpayer Relief Act of 2012.

[3.2] REG-131239-13 (May 27, 2014), 2014-22 I.R.B. 1064, publishing Prop. Reg. § 1.381(a)-1(b)(2)(i).

[3.3] Prop. Reg. § 1.381(a)-1(b)(2)(i).

PART THREE: TAXATION OF S CORPORATIONS

CHAPTER 15. S CORPORATIONS

C. ELECTION, REVOCATION AND TERMINATION

Page 671:

At the end of footnote 3, insert:

See also Rev. Proc. 2013-30, 2013-36 I.R.B. 173, which consolidates and modifies previous guidance and provides simplified methods for taxpayers to request relief for late S corporation elections.

F. TAXATION OF THE S CORPORATION

Page 694:

At the end of footnote 3, insert:

For tax years beginning in 2009 or 2010, the recognition period in Section 1374(d)(7) was reduced from ten to seven years and then further reduced to five years for 2011. The American Taxpayer Relief Act of 2012 extended the shorter five-year recognition period for two more years, through the end of 2013, when this temporary provision expired. As of early July 2014, a bill passed by the House (H.R. 4453, the S Corporation Permanent Tax Relief Act of 2014) would have reinstated the five-year recognition period and made it permanent. But an ongoing stalemate with the Senate over whether to extend various expired temporary tax provisions and, if so, whether or not to pay for them with revenue offsets, makes it unlikely that any action will be taken until after the 2014 Congressional elections, if then.

H. COMPENSATION ISSUES

Page 705:

At the end of footnote 1, insert:

In 2014, the employer and employee's Social Security (FICA) tax rate are 6.2 percent each, with the expiration at the end of 2012 of the two percent "tax holiday" on the employee's share. The wage base for 2014 is $117,000. For most taxpayers, the Medicare tax rate remains 1.45 percent on both employer and employee (and 2.9 percent for self-employed taxpayers), with no cap on the amount subject to tax. Beginning in 2013, an additional 0.9 percent Medicare tax on combined wages and self-employment income in excess of $250,000 for married filing jointly taxpayers ($200,000 for single taxpayers and $125,000 for married filing separately) became effective. I.R.C. § 3101(b)(2). As a result, the Medicare tax rate for these "high-income" taxpayers with earned income has increased from 2.9 to 3.8 percent for amounts over the thresholds. Also beginning in 2013, a 3.8 percent tax is imposed on the lesser of a taxpayer's "net investment income" or adjusted gross income (with some modifications) in excess of $250,000 for joint filers, $200,000 for single taxpayers and heads of household, and $125,000 for married filing separately. I.R.C. § 1411.

Page 709:

After the second full paragraph, insert:

Net Investment Income Regulations. In late 2013, the Service issued final regulations interpreting the 3.8 percent tax on net investment income in meticulous detail.[11.1] The regulations include the general operating rules applicable to Section 1411; specific provisions for individuals, estates, and trusts; an intricate technical definition of net investment income; and lots of highly specialized rules. The regulations confirm that net investment income items and properly allocable deductions of partnerships, LLCs and S corporations are determined at the entity level and pass through to their partners, members and shareholders. At the same time, the Service issued new proposed regulations to provide further clarification on specific types of activities, including the disposition of partnership interests and S corporation stock.[11.2]

The regulations are must reading for tax advisors to clients with investment income, but for now we are declaring them beyond the scope of sensible "fundamentals" coverage in a law school corporate tax class.

[11.1] T.D. 9644, 2013-51 I.R.B. 676.

[11.2] REG-130843-13 (Nov. 26, 2013), 2013-51 I.R.B. 771. See Prop. Reg. § 1.1411-7.