Ch. 14 Corporate Tax
Anti-avoidance Rules

In the U.S. corporate income tax context U.S. Treasury Department has concerns about:
1) Avoidance of the double tax on corporate/shareholder taxation.
2) Avoiding high marginal tax rates for individuals, including through the use of corporate entities.
3) The significant reduction of corporate tax liabilities through corporate tax shelters, and similar arrangements (e.g., leasing arrangements).
Anti-Avoidance Rules in this Chapter 14

1) **Economic substance doctrine** – tax common law doctrine transformed into a statutory provision.

2) **Accumulated earnings tax** – p. 626. Penalty tax is imposed when a corporation is “availed of” to avoid the shareholder level tax. Individual rates are higher than corporate rates.

3) **Personal holding company tax** – p. 645. Can not use a corporation as one’s individual “pocketbook” (& accumulate income in a corp. taxed at a lesser income tax rate).
Corporate Tax Shelters
Basic Premises p.611

1) Realize a tax loss without an economic loss.
2) Income is deflected to a “tax-indifferent party.”
3) Exploit Code language ambiguities.
4) Secrecy of the deals/Confidentiality requirements are imposed on the deal.
5) Differences between tax & financial accounting.
6) Tax counsel “reasoned (?) opinions.”

Plus: exploit the “audit lottery.”
Prior Attempts to Limit Corporate Tax Shelters

1) IRS litigation strategy (case-by-case).
2) Disclosure of tax shelter investments required, including the registration of tax shelters. See IRS Notice 2009-59 with a list of tax shelters.
3) An increased no fault “substantial understatement” penalty.
4) Penalties for failure to disclose.
5) Enhanced requirements on the conduct of professionals re opinions. Treasury Circular 230.
Economic substance?

UPS organized offshore subsidiary (OPL) to provide reinsurance for excess value insurance on shipments. Why use National Union in the deal? OPL shares were distributed to UPS shareholders. Issue re whose income for the “excess value” net amount - economically realized by OPL or UPS? Real economic substance to this arrangement? Held: Not a “sham” transaction; adequate business purpose existed; but, is §482 applicable? P.616. 

continued
Economic substance?

Dissent: Was there any legitimate, substantive business reason?

Tax Court decision that subjective motivation was tax avoidance. Plus, not real economic or business purpose. Only for tax avoidance purposes. Plus, OPL was charging an inflated rate for its services.

See earlier §482 discussion at p. 592 in casebook.
1) Economic substance doctrine: Transactions are to have “economic substance” separate and apart from the economic benefit achieved merely from the income tax reduction obtained. A meaningful change to the taxpayer’s economic position must occur.

2) Business purpose doctrine (p.619): was a non-tax objective sought to be achieved? Are both requirements to be satisfied? P.620

continued
Do financial accounting (i.e., GAAP) benefits provide a non-tax business purpose? No. P.621

Consider the relevance of “tax-indifferent” parties as being included in a transaction. What/who is a “tax indifferent” party?

Ultimate question: Does this transaction satisfy the “economic substance doctrine”? P.621
Economic Substance Doctrine Codified p.622

§7701(o) is entitled a “clarification” of economic substance doctrine, i.e., a “common law” doctrine. A transaction has “economic substance” only if (1) transaction changes in a meaningful way the taxpayer’s economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Code §7701(o)(1).

I.e, the “conjunctive test” applies.
Economic Substance Doctrine Codified, cont.

§7701(o)(2)(A) – a pre-tax profit potential is to be substantial in relation to the present value of the expected net tax benefits.

§7701(o)(2)(B) – Transaction expenses are to be taken into account as expenses in determining pre-tax profit.

And, a financial accounting benefit is not taken into account for legitimating the transaction.

§7701(o)(4).
The Protected “Angel List”
p.624

- Debt v. equity.
- Domestic or foreign entity.
- Corporate organization or reorganization.
- Related party transactions (outside §482).

Plus, use of specific statutory tax incentives.

But, IRS does not confirm this listing.

Proceeding with a corporate acquisition transaction structured as a stock-for-stock exchange but (1) with minimal cash included so as to frustrate “B” reorg. status, and (2) therefore, trigger loss on Target stock to get the tax benefit of an accrued loss on the stock being transferred.

Is this structured “failed B reorg” transaction subject to, and is loss utilization limited by, applicability of the “economic substance” doctrine?
(a) Is the “economic substance” doctrine even relevant here? See §7701(o)(5)(C).

Is the relevancy of this doctrine determined on whether §7701(o) is applicable in a pre-enactment situation?

If not applicable, then, the “no boot in a “B” rule” should be controlling and loss realization should be recognized (the economic substance doctrine then not being relevant).
(b) Assuming the “economic substance” doctrine is relevant here: If so, then how apply the two tests –
1) Was there a meaningful change in the taxpayer’s economic position? and,
2) Did the taxpayer have a substantial non-tax purpose for entering into this transaction?

Desire to recognize a tax loss existed; there was a meaningful change in economic position; economic loss existed before the transaction. But, could have sold the stock for cash. continued
Should this transaction be on a deemed acceptable transaction “angel list” (see JCT report), since taxpayers should be able to structure transactions as complying with (or not) various statutory provisions (e.g., 351, 368, 332, 1031, and other Code non-recognition provisions).

Conclusion: This is not the type of transaction intended to be penalized through the enactment of §7701(o).
Accumulated Earnings Tax
“C” Corporations  p. 626

Issue: Can a corporation be used as the temporary location for assets after incurring a (lower) corporate tax rate and before (if at all) incurring a second, higher income tax rate for shareholders?

Incentive to avoid applicability of accumulated earnings tax by stripping earnings from a corporation on a tax deductible basis (e.g., compensation and fringe benefits)?

Wait for a redemption transaction to extract earnings on a low taxed basis (i.e., capital gains)?
Accumulated Earnings Tax
Imposition p. 627

Tax is imposed at 20 percent of the C corporation’s “accumulated taxable income.”
Accumulated earnings credit (offset) of up to $250,000 (Code § 535(c)(2)); limited to $150,000 for personal service corporations.
Retention of “accumulated taxable income” in determining evidence of purpose to avoid income tax. Code §§ 533 and 537.

Is AET applicable to publicly held corporations?
Myron’s Enterprises, p. 630 – determining the amount necessary to be retained for the “reasonable needs of the business.”

Held: all accumulations for “reasonable needs.”

Reasonably anticipated needs included the funds to buy the building where the business was located.

Did a specific, feasible plan exist?

Need not consider the capacity of shareholder to lend to the corporation.
Reasonable Needs of the Business

1) Expansion of plant or equipment.
2) Make business purchase (stock or assets).
3) Retire corporate debt.
4) Working capital for the business.
5) Customer & supplier financial support.

Not for loans to insiders and for unrelated passive investments by the corporation.
Concept of “Working Capital” p.637

Bardahl formula: How much capital is needed to cover one operating cycle?

Cycle includes (1) purchase of raw materials, (2) processing into finished goods, (3) selling the product, and (4) collecting on accounts receivable.

What if a delay in paying the payables (e.g., for raw materials)? Reduce the length of the operating cycle?
Retained funds were used to purchase stock at an excessive price so that stock was not acquired by outsiders.

Holding: diversion of accumulated earnings for this purpose did not reflect an unreasonable accumulation.
Problems

(a) Annual retention of earnings to finance expansion of its manufacturing plant. But, could have borrowed funds to this expansion.

Result: Reasonable needs requirement satisfied, but must have reasonable definitive plans.

(b) Manufacturing corporation accumulates funds to buy/net lease a building to an insurance co.

Result: Probably not an active business. See Reg. §1.537-3(a) which does permit retention for any business.
Problems p.644

(c) Parent’s retention of earnings to assist related corporations. Result: OK to accumulate for active business subsidiary only. Reg. §1.537-3(b).

(d) Accumulation of funds for potential §531 liability. Result: Not for the reasonable needs of the business. But, if accumulating for this purpose, an “admission against interest” when a §531 challenge?
(e) Accumulation of funds to redeem a class of limited and preferred stock. Result: Not a reasonable need of the business, subject to an exception for a §303 redemption. See §537(b)(1) or (2).
Problem 2 – Accumulated Earnings Tax Amount p.645

E&P (year 1) of $200,000. Then taxable income of $60,000 for years 2, 3 & 4.

(a) Tax results: Minimum credit of $250,000. Year three – over $250,000 base.

(b) Defenses – assert reasonable needs of the business.

(c) §534 impact? Shift the burden of proof to IRS.
Personal Holding Company Tax

Special tax to preclude:
1) “Incorporated pocketbooks”
2) Incorporated talent
3) Incorporated properties – subject to a lease to shelter lease income which is deducted by the shareholder tenant payor.
Stock ownership requirement - §§ 542(a)(2) & 544.

Definition: PHC status if more than 50 percent in value of the corporation’s outstanding stock is owned by or for note more than five individuals.

Attribution of ownership rules (under §544(a)) are applicable to determine this ownership.
Personal Holding Company Definition

Income test - §542(a)(1) & §543.
At least 60 percent of the corporation’s adjusted ordinary gross income must be “personal holding company income.”

What is personal holding company income?
Passive income such as dividends interest, annuities, royalties and rental income (but only if being less that 50 percent of total gross income). & certain services income.
§543(a)(7) specifies that PHC income includes certain income received under a personal service contract – if some other person has the right to designate the individual to perform the services. Physician-patient relationship does not constitute such a designation, unless the physician has no right to substitute the performer. Consider the contract with the specialist heart surgeon.
Corporate lessor and corporate lessee and both corporation are owned by the same individual. Is the rent PHC income?

§543(a)(6)(A) – PHC income where lessor corp. at least 25% owned by individual who can use the property. And, only (§543(a)(6)(B)) where lessor corporation has PHC income exceeding 10% of its ordinary gross income. Not applicable where corp. to corp. lease arrangement & property used in trade or business.
1) Adjustments to taxable income. PHC taxed based on after-tax income. Deduction from PHC tax base for certain payment, e.g., federal income taxes.

2) Dividends paid deduction – PHC tax not applicable to distributed earnings. Includes actual dividends and consent dividends & deficiency dividends.
PHC status?

a) Not a PHC since income from active business.

b) $30,000 of PHC income. Note: even manufacturing companies can be caught in the PHC net.

c) §1231 gain not included for this purpose. §543(b)(1)(B). §1245 gain is included. But, PHC income is less than 60% of AOGI.
Personal Holding Company Tax – Problem 2  p.658

PHC status?
a) All corporation’s income is PHC income. §543(a)(7).
b) Attempt to increase gross income to get to below 60% of adjusted ordinary gross income.
PHC status?

a)