SUMMER 2015

STUDENT UPDATE MEMORANDUM

FUNDAMENTALS

OF

CORPORATE TAXATION

Eighth Edition

By

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This Summer 2015 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 three 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, a few published revenue rulings, 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, 2015.

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San Francisco, California
July 2015
PART ONE: INTRODUCTION

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

A. INTRODUCTION

2. INFLUENTIAL POLICIES

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 2015 are: $464,851 for married filing jointly taxpayers, $413,201 for unmarried filers, $439,001 for heads of household, and $232,426 for married filing separately taxpayers. Congress also finally indexed 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.

ATRA 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 2015 are: $309,900 for married filing jointly taxpayers, $258,250 for unmarried filers, $284,050 for heads of household, and $154,950 for married filing separately taxpayers. These thresholds, which are different from those used as the starting point for the 39.6 percent marginal bracket, also are 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 2015, the Social Security tax wage base increased to $118,500 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 once again 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 (which are not indexed): $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 corporate income tax rate reductions in exchange for broadening the tax base but neither offering much specificity on what “loopholes and subsidies” to eliminate. Since then, a meandering discussion comes and goes in Congress and elsewhere, as both the House Ways and Means and Senate Finance Committees deliberate over goals, 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.), who has since retired from Congress, 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 making several significant changes to the taxation of partnerships, LLCs and S corporations. The more radical second option proposes to 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 limit flexibility for partnerships and limited liability companies.

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.
In early 2014, then House 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. The extensive business tax reforms in Chairman Camp’s bill included 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.

In 2015, the Senate Finance Committee, under new leadership, formed various tax reform working groups, one of which focused on business tax issues. A comprehensive Business Income Tax Bipartisan Working Group Report was issued in July 2015 and is available at http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959. The report does not suggest any specific business tax reform plan but attempts to explore certain “threshold issues” and describe “principles, considerations and options,” as well as the trade-offs inherent in any serious tax reform effort. It contains the usual list of weaknesses in the current tax system, such as: promotion of inefficiency by incentivizing businesses to make decisions (e.g., choice of form) based on tax rather than business considerations; a statutory corporate income tax rate that is higher than most other developed countries, placing the United States at a competitive disadvantage in the global economy; and fostering of uncertainty through the use of temporary provisions that frequently expire and are reenacted late in the year when there is little or no time to benefit from them.

The Working Group agreed on several familiar principles to drive business tax reform: (1) lowering tax rates to encourage economic growth and job creation and to create an internationally competitive tax code; (2) addressing structural biases (e.g., debt financing over equity); (3) promoting innovation (e.g., through a permanent research and development tax credit and source neutral incentives for energy production; and (4) simplifying the system.

The Working Group’s report does not break much new ground, but it does a good job outlining the challenges and trade-offs in any serious business tax reform discussion. For example, there is bipartisan support for lowering statutory corporate tax rates but sharply differing views on how or whether to pay for the rate reduction by broadening the tax base, such as by scaling back accelerated depreciation and other corporate tax expenditures. Another challenge (some would say obstacle) is a concern that pass-through entities, which now represent more than 90 percent of all American businesses, would be treated inequitably if corporate rates were reduced because most of their income would be taxed at higher marginal individual rates. Owners of pass-through entities also might bear an increased effective tax rate if the tax base is broadened.

Despite all this hard work, prospects for serious reform are slim to none in the current political environment. The talk will continue through the next election cycle, with competing narratives, and the future direction and shape of tax reform will be influenced by the outcome of the 2016 Presidential election and the balance of power in the next Congress.
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). 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. 13. Reg. § 1.362-4(g)(5).

Page 60:

Add to part (a) of the Problem:

Part (a) cites Reg. § 1.453-9(c)(2). Prop. Reg. 1.453B-1(c) would republish the general rule in Reg. § 1.453-9(c)(2) that when the Code provides an exception to the recognition of gain or loss, then gain or loss is not recognized on the disposition of an installment obligation within the exception. See REG-109187-11 (Jan. 12, 2015). The proposed regulation was issued to reflect earlier changes made to Section 453. The rules about dispositions of installment obligations currently in Section 453B were at one time in Section 453.

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 100 percent exclusion has been extended several times since then and currently applies to eligible stock acquired before January 1, 2015. It likely will be extended again before the end of 2015. 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 2012 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:

Now that the Supreme Court has declared the Defense of Marriage Act unconstitutional and held that the fundamental right to marry is guaranteed to same-sex couples by the Fourteenth Amendment, each party to a same-sex marriage 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:


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 version. 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 the seller and target corporations attach Section 336(e) election statements to their tax returns.\textsuperscript{13}

And there is lots more, including a relaxation of the definition of “related party” as it applies to partnerships.\textsuperscript{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).\textsuperscript{15}

\textsuperscript{10}Reg. § 1.336-1(b)(3).
\textsuperscript{12}Reg. § 1.336-2(b)(2)(iii).
\textsuperscript{13}Reg. § 1.336-2(h).
\textsuperscript{14}See Reg. § 1.336-1(b)(12).
\textsuperscript{15}See, e.g., Reg. § 1.336-2(k).
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:

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.

E. USE OF SECTION 355 IN CORPORATE ACQUISITIONS

1. LIMITATIONS ON USE OF SECTION 355 IN TAXABLE ACQUISITIONS

c. DIVISIVE TRANSACTIONS IN CONNECTION WITH CERTAIN CHANGES OF OWNERSHIP

Page 509:

In footnote 12, insert:

The IRS has issued final and temporary regulations under Section 337(d) designed to prevent corporations from avoiding General Utilities repeal through transactions involving partnerships. See Reg. §§ 1.337(d)-3T, 1.732-1T. An understanding of the details of the regulations requires a grounding in both corporate and partnership taxation and is thus well beyond the “fundamentals” of corporate tax. The issues addressed in the regulations, however, can be explained in a simplified form. Sections 311(b) and 336(a) require a corporation that distributes appreciated property to its shareholders to recognize gain as if the property were sold for its fair market value. In contrast, Section 721 provides that a contribution of property to a partnership is a nonrecognition event, and Section 731(a) allows a partner to receive a distribution of noncash property from a partnership in a nonrecognition transaction. Thus, these provisions provide a potential avenue for avoidance of General Utilities repeal when appreciated property is transferred out of a C corporation. Here is a simple example. Suppose X Co. enters a partnership by contributing an appreciated asset. The partnership then acquires X Co. stock and later makes a liquidating distribution of that stock to X Co. Under the partnership taxation rules, the contribution of the appreciated asset by X Co. to the partnership and the receipt of its own stock could be tax free, with the result that X Co. would have potentially exchanged appreciated property for its own stock and avoided gain recognition. If that were the case, the rules in Section 311(b) and 336(a) would be avoided! The final and temporary regulations address this problem by identifying transactions that are equivalent to an exchange by a corporation of appreciated property for its stock (a “Section 337(d) Transaction”) and taxing them as deemed redemptions. But be warned. These regulations are laden with complexity. They
interweave the rules of Subchapter K and *General Utilities* repeal in a labyrinth of definitions and special rules.

**CHAPTER 11. NONACQUISITIVE, NONDIVISIVE REORGANIZATIONS**

**B. NONDIVISIVE TYPE D REORGANIZATIONS**

**Page 540:**

At the end of footnote 8, insert:

The regulation for the basis consequences to target shareholders in an all-cash D reorganization has been finalized by *T.D. 9702 (Nov. 24, 2014)*. The citation should be Reg. § 1.358-2(a)(2)(iii).

**Page 541:**

After the carryover paragraph, insert:

The IRS has issued two revenue rulings that provide flexibility and certainty for tax advisers regarding certain internal corporate restructuring transactions. *Revenue Ruling 2015-9*, 2015-21 I.R.B. 972 involved a transaction known as a “drop and sideways merger.” P, a domestic corporation, owned all of the stock of two foreign subsidiaries, S-1 and S-2. S-1 directly operated a business while S-2 was a holding company that owned all the stock of three foreign operating companies, X, Y, and Z. All of P’s subsidiaries were incorporated in the same country. As part of a prearranged plan with a valid business purpose, P’s agenda was to combine the operating companies (S-1, X, Y, and Z) into N, a new foreign subsidiary of S-2. To achieve that result, P first transferred all of the stock of S-1 to S-2 in exchange for additional shares of S-2 stock. Immediately after that transfer, S-1, X, Y, and Z transferred substantially all of their assets to N in exchange for N shares. S-1, X, Y, and Z then liquidated, distributing all of the N stock to S-2. The IRS ruled that the first step of the transaction, P’s transfer of S-1 to S-2, was a nontaxable Section 351 exchange. The subsequent transfers and liquidations by S-1, X, Y, and Z were treated as tax-free reorganizations under Section 368(a)(1)(D).

*Revenue Ruling 2015-10*, 2015-21 I.R.B. 973, involved a restructuring known as a “triple drop and check.” A domestic corporation, P, transferred its interest in a limited liability company that had elected to be taxed as a corporation, to a subsidiary, S1, for S1 stock. S1 then transferred the LLC to another subsidiary, S2, for S2 stock, and S2 next transferred the LLC (this was the third “drop”) to yet another subsidiary, S3, for S3 stock. The LLC then “checked the box,” electing to be a disregarded entity no later than one day after S2’s transfer. The ruling holds that the transfers by P and S1 were nontaxable Section 351 exchanges. The election by the LLC to be disregarded and the transfer by S2, however, were characterized as an acquisitive Type D reorganization followed by a Section 332 liquidation.

The outcome of these rulings is hardly surprising because no assets were removed from corporate solution in either transaction and control of P was unchanged. The reasoning reflects the
IRS’s policy to respect the form of a Section 351 exchange even if it is followed by subsequent transfers of the contributed property as part of a prearranged, integrated plan. But the rulings also confirm that the IRS is prepared to apply the step transaction doctrine to deny Section 351 nonrecognition or otherwise recast the separate steps of an integrated transaction if “a different treatment is warranted to reflect the substance of the transaction as a whole.”

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. Regulations issued in 2014 (T.D. 9700, Nov. 24, 2014) provide that only a single “acquiring corporation” may succeed to the target’s earnings and profits. 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. Similar regulations also issued in 2014 adopt a stricter but simpler approach with respect to all tax attributes governed by Section 381, not just E & P. 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.

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3.1 Reg. § 1.312-11(a).

3.2 Reg. § 1.381(a)-1(b)(2)(i).

3.3 Id.
CHAPTER 14. ANTI-AVOIDANCE RULES

B. THE ECONOMIC SUBSTANCE DOCTRINE

3. CODIFICATION

Page 625:

After the second full paragraph, insert:

In Notice 2014-58, 2014-48 I.R.B. 746, the IRS provides additional guidance on the operation of the economic substance doctrine under Section 7701(o) and the Section 6662(b)(6) penalty. The Notice provides that a “transaction” for purposes of Section 7701(o) generally includes “all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan.” Facts and circumstances determine whether a plan’s steps are aggregated or disaggregated when defining a transaction.” Generally, this standard requires aggregation of all interconnected steps with a common objective. But if there is a tax-motivated step that is not necessary to achieving a non-tax goal, the “transaction” may include only the non-tax step; i.e., a disaggregation approach could apply. Thus, disaggregation and the relevance of the economic substance doctrine are applied to some extent on a case-by-case basis under an all facts and circumstances approach designed to provide the IRS with maximum flexibility.

Section 6662(b)(6) imposes a no-fault penalty to an underpayment attributable to disallowance of claimed tax benefits by reason of a transaction lacking economic substance under Section 7701(o) or failing to meet the requirements of any similar rule of law. Notice 2014-58 interprets the phrase “similar rule of law” as meaning a rule or doctrine that disallows the tax benefits under subtitle A of the Code related to a transaction because:

(1) the transaction does not change a taxpayer’s economic position in a meaningful way (apart from Federal income tax effects); or

(2) the taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

Thus, the Notice explains “similar rule of law means a rule or doctrine that applies the same factors and analysis that is required under Section 7701(o) for an economic substance analysis, even if a different term or terms (for example, “sham transaction doctrine”) are used to describe the rule or doctrine.”

In Notice 2014-58, the IRS also announces that it will not apply a penalty under Section 6662(b)(6) unless it also invokes the codified economic substance doctrine to support the underlying adjustments. So if the IRS does not raise Section 7701(o) to disallow the claimed tax benefits and instead relies upon other judicial doctrines (e.g., the substance over form or step transaction doctrines) to support the underlying adjustments, the IRS will not apply a section 6662(b)(6) penalty.
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.
PART THREE: TAXATION OF S CORPORATIONS

CHAPTER 15. S CORPORATIONS

C. ELECTION, REVOCATION AND TERMINATION

Page 671:

At the end of footnote 3, insert:


D. TREATMENT OF THE SHAREHOLDERS

2. LOSS LIMITATIONS

a. IN GENERAL

Page 685:

At the end of the Note, insert:

In T.D. 9682 (Aug. 11, 2014), the IRS issued final and temporary regulations relating to basis of indebtedness of S corporations to their shareholders. They provide that shareholders receive basis in such indebtedness if it is “bona fide” indebtedness of the S corporation to the shareholder. Whether the indebtedness is bona fide is determined under general tax principles and depends on all facts and circumstances. Reg. § 1.1366-2(a)(2)(i). The regulations make it clear that the all facts and circumstances rule applies regardless of how the indebtedness arises. The examples in the regulations include a loan directly from a shareholder to an S corporation; a back-to-back loan arrangement where one S corporation makes a loan to a shareholder and the shareholder then loans money to a different S corporation; and a loan restructuring where an individual who is the sole shareholder of two S corporations receives the loan of one corporation to the other in a distribution. See Reg. § 1.1366-2(a)(2)(iii) Examples 1-3. A special rule applies for shareholder guarantees of S corporation indebtedness. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to the loan. But when a shareholder makes a payment on a bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, the shareholder then may increase the basis of indebtedness to the extent of the payment. Reg. § 1.1366-2(a)(2)(ii).
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. In late 2014, it was extended again for another year, but for tax years beginning in 2015 the recognition period is back to 10 years. As this Update Memorandum was being completed, legislation to reduce the recognition period yet again, either temporarily or permanently, was pending in both the House and Senate. See Staff of the Joint Committee on Taxation, Description of the Chairman’s Mark of a Bill to Extend Certain Expired Tax Provisions (JCX-101-15), July 17, 2015, available at http://www.jct.gov/publications.html?func=startdown&id=4800.

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 2015 is $118,500. 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.\textsuperscript{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.