Corporate Taxation

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Relevance of this Corporate Taxation Course

Federal income tax planning concerns:

1. Choice of business enterprise form.
2. Capital structure of the enterprise, e.g., debt or equity (or both).
3. Dividend/profits distribution policies.
4. Compensation policies.
5. Disposition of corporate interests.
6. Estate planning/wealth transfers.

Business Entity Choices

- Corporation - “C” or “S” status
- Partnership - general or limited
- Limited Liability Company (LLC)
- Trust or Estate (available for business?)
- Sole Proprietorship
- Disregarded Entity (DRE)
- RICs & REITS & other flow-throughs
- Special entities, e.g., banks & insurance co.

Corporate or Non-Corporate Status?

Pre-2017 Act:

Corp. – 35 percent tax rate

Individuals – 39.6 percent rate

After 2017 Act:

Corp. – 21 percent tax rate

Individuals - 37 percent tax rate (but deduction of 20 percent on "qualified business income" – Code §199A; effective rate of 29.6 percent on this income).

Fundamental Corporate Tax Technical Issues

1. Contributions <u>into</u> the corporation – is gain recognition required to either party?
2. Arrangements between owners & the entity – e.g., is an "assignment of income" permitted?
3. Distributions of (appreciated) property taxable?
4. Corporate liquidations, including sales in conjunction with a corporate liquidation.
5. Corporate "reorganizations" - possible postponement of gain recognition on stock transfer.

“Cradle to Grave” Approach in this Course

1. What is a “corporation”?
2. Organization - §351   Note: Code §61.
3. Is tax applicable to corporate level income?

(a) Entity level tax or (b) flow-through treatment?

4. Capital structure - Debt vs. equity

- Is an interest expense deduction available?
- Is tax-free repatriation of debt available?

5. Dividends – income tax treatment?   *continued*

“Cradle to Grave”, cont.

6. Significant interim distributions:
 - Redemptions & partial liquidations
 - Stock dividends
 - §306 stock distribution (indirect dividend?)
7. Terminating the stock ownership interest
8. Taxable complete or partial liquidations
9. Corporate tax-free reorganizations

Corporation/Shareholder Tax Policy Issues p.5

1) Double taxation, i.e., at the corporate and the shareholder level; but, 2003 Act.

How moderate the effect of the double tax?

- Interest expense for debt financing
- Other deductions, e.g., payment to insiders
- Retain earnings inside the corporation (including as an internal funding source)
- Reduce tax on dividend distributions.

Incidence of Corporate Tax p.6, fn. 17

Who bears the burden of the corporate tax?

1) The corporation? (an artificial entity)

"corporations are people" - M. Romney

2) Shareholders/owners?

3) Employees? Suppliers?

4) Corporate managers?

5) Consumers of the corporation's output?

6) Other investors? The community?

Corporation/Shareholder Tax Issues, cont.

2) Tax rates on ordinary income - p.8 corporation and shareholder;

Dividends are <u>not</u> taxed as ordinary income after the 2003 Act? What happened in 2013? & what effect of the 3.8% Medicare tax?

3) Preferential capital gains rates. p.11

4) Gain non-recognition possible upon asset ownership shifts. Formation & reorgs. p.11.

The International Dimension p.12

This course is limited to <u>domestic</u> taxation.

However, the world is transnational.

Therefore, how treat foreign based income?

§11 applies on a worldwide basis (rather than a territorial approach) to U.S. corp. taxpayers, with a foreign tax credit available. Use inversion?

Foreign subsidiary income is not taxed.

Therefore, shift income to the foreign sub.?

Concepts of "Tax Common Law" p.14

<u>Non-codified</u> federal income tax rules (particularly relevant in the <u>corporate</u> income tax context):

1) The "sham transaction" rule (p. 15).
2) Economic substance doctrine (p.16). §7701(o).
3) "Substance over form" analysis (p.16).
4) The "business purpose" doctrine (p.17).
5) The "step transaction" doctrine (p.17).

Income Taxation of the Corporation p.18

1) Code §11 – 21 percent income tax rate.
- previously multiple tax brackets.
2) Determination of the corporation's <u>taxable</u> income – no "above the line" vs. "below the line"; why?
  - a dividends <u>received</u> deduction <u>is</u> available.
  - deduction for domestic production - §199. p.21
3) Accounting period – is the <u>calendar year</u> required?
4) Accrual method of accounting? §448(a). p.22; exception for a qualified PSC or a small enterprise.

Income Taxation of the Corporation, cont. p.23

5) Code §267 – limitations on transactions between corp. & their owners, i.e., limiting potential "gaps."

6) Corporate Alternative Minimum (ALTMIN) Tax – p.24. Flat rate tax on a broader income tax base.

Repealed after 2017.

7) Multiple corporations - §1561 limit on controlled group multiple tax benefits – p.27.

Cf., consolidated tax return treatment for an affiliated group of corporations - §§1501-1504. p.27

8) The "S" corporation alternative – p.28 (next slide).

S Corporation comparison p.29

S Corp. vs. Partnership vs. LLC -

Important variances:

1) Shareholder tax basis increase for partnership debt; no basis increase for S Corp debt for S Corp shareholders, unless sourced from shareholders.

2) More income allocation flexibility re partnerships.

3) Employment tax planning – pay no compensation to S corporation shareholder/employee, but pay dividends to the shareholders (to avoid social security and medicare taxes).

Problem - page 31
C Corporation Scenario

(a) Determining corporate level <u>gross income</u>:

Inventory sales	2,600,000
Capital gains	<u>200,000</u>
Gross income	2,800,000

Exclusion under §103 for $10,000 muni-bond interest received.

continued

Problem - page 31 Deductions Against GI

Operating expenses	800,000
Depreciation (ACRS)	800,000
Capital loss (220, but limit to gain)	200,000
Total deductions	1,800,000
Equals: Taxable income	1,000,000
(2.8 less 1.8 = 1.0)	

continued

Problem - page 31 Determining Tax Liability

§ 11(b)(1) tax calculation on $1 million taxable income (2.8 gross less 1.8 deductions):

21%	210,000
Total regular tax liability	<u>210,000</u>

<u>Cash remaining inside corp is $790,000.</u>

Problem (b) - page 31 Dividend distribution

Distribution of $790,000 after-tax profit.

§61(a)(7) dividend income

20% percent of $790,000 =	$158,000
Total taxes: (210 + 158)	$368,000
Amount for shareholders:	$632,000
Effective tax rate:	36.8 percent

(is a 36.8% effective tax rate too much?)

Problem (c) - page 31 Deductible (?) payments

1) $500,000 salaries paid - to eliminate all corporate level taxable income.
Is this a reasonable compensation amount?
Then net $300,000 to each shareholder (after 40% individual tax on salaries). Cf. $316,000 above.
2) Other corporate level deductions available for this purpose? Debt/interest & property/rents?
Double benefit situations? §79 - group term Insurance; §§105 & 106 - health benefits.

Definition of "Corporation" Code §7701(a)(3) p.32

Choices of business entities: (see chart)

1. Regular corporation
2. S corporation
3. Foreign corporation
4. Limited liability company - LLC
5. Limited partnership, including "MLP"
6. General partnership
7. Sole proprietorship (& the "tax nothing")

Prior Entity Classification Criteria - Tax Regs.   P.32

1) Associates - both corp. & partnership

2) Business objective – both corp. & partnership

3) Continuity of life

4) Centralization of management

5) Limited liability for debts of the entity

6) Free transferability of interests - but buy-sell agreement not treated as limiting transferability.

Regs. had bias *towards* partnership status (if not more than 2 of last 4 characteristics). Corp. if 3 of 4 elements. Effect of the tilt towards partnership?

"Check the Box" Regulations p.34

Premise: Regulations make the choice of entity *optional* to the taxpayer.

1) But, automatic classification of certain entities as corporations - *per se* treatment; including domestic & specifically enumerated foreign corporations.

2) Default partnership status - an "eligible entity" may elect to the contrary. To be eligible in the foreign context one party must have unlimited liability; or, both must consent. How achieve this "consent" when a foreign LLC is an owner?

Additional Entity Classification Issues p.35

1) The "tax nothing" or disregarded entity - See Rev. Proc. 2002-69 re community property shareholder status (either a DE or PTN). How?

2) What income tax effect of a change in the number of members of an entity? Change in status?

3) What income tax effect of elective changes in tax classification of the entity? P.36.

a) From partnership (or DE) into corporation?

b) From corporation to partnership?

The "Publicly Traded Partnership" §7704 p.37

- Corporate treatment of a "publicly traded partnership"? IRC § 7704. Trading "units."
- What is "publicly traded" for this purpose?
- Reason for an exception from corporate status classification where 90% of more of the entity's income is "passive"? Cf., a RIC or REIT.
- Including income from natural resource activities?
- See §7704(d)(1)(E) re various other exceptions from PTP categorization. But, see §7704(c).

Corporations vs. Partnerships vs. Trusts P.38

See Reg. § 301.7701-4 - the purpose of a trust is to "protect or conserve" property, but not to conduct a business. If doing so, the trust then has either:

(1) partnership status or (2) corporate status for the entity? Types of "trusts" which may exist:

- personal wealth management
- oil royalty trusts
- equipment leasing/airplane trusts

continued

Trust Income Taxation p.38 Subchapter J Rules

1) Grantor trusts: IRC Subchapter J, Subpart E, § 671 et. seq., grantor treated as the "owner"

- income taxation directly to the grantor.

2) Nongrantor trusts: Subparts A-D (of Subch. J) taxation to: (a) the trust (if no distribution); or (b) the beneficiaries to the extent of actual distributions (or required distributions), applying the "DNI" concept (but not to undistributed trust income).

Recognition of the Corporate Entity p.39

I.e., is the corporation required to be treated as a tax entity <u>separate from its shareholder</u>?

<u>Bollinger case</u>: to avoid usury rules, corporation holds title to real property as an "<u>agent</u>" for shareholder of the corporation and not as an "owner" (for tax purposes) .

Held: Agency status was permitted &, therefore, tax losses were directly allowable to the individual investors (including through partnerships).

National Carbide Factors p. 41

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 is attributable to services of the employees of the principal;

continued

National Carbide, cont.

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 <u>carrying on of the normal duties of an agent.</u>

Issue for the tax advisor: How assure agency status for income tax purposes?

Corporation/Shareholder Tax System Integration

U.S. has a <u>classical</u> tax system, i.e., taxation both on (1) the corporation and (2) the shareholder.

Who pays the corporate tax:

the corporation or the shareholders?

How eliminate double taxation (if desired)?

The <u>full integration</u> option: complete flow-through, e.g., the ALI proposal of:

(1) Income imputation, and (2) tax withholding (for U.S. Treasury cash flow availability).

Partial corporate shareholder integration

1. Shareholder credit for tax previously paid on the dividend amount - subject to an income "gross-up" requirement (cf., wage withholding).

2. Deduction available to the distributing corporation for the dividend paid.

3. Shareholder gross income exclusion for all or part of corporate dividend. 2003 Act - reduce individual dividend tax to 15% (extended through 2012 & then – 20%). Foreign corps? See §1(h)(11)(C)(i)(II) – re treaty.

Special concerns about integration proposals

1. Extension of corporate tax preferences to shareholders (& limited corporate level tax).
2. Treatment of tax-exempt shareholders (e.g., §401 deferred compensation plans & charities).
3. Treatment of foreign shareholders (only through tax treaty?) - 30% under 2003 Act.
4. Treatment of foreign taxes paid by the U.S. corporation. Not creditable against U.S. income tax?

Distortions Tilting Towards Non-Corporate Status

1) Higher effective income tax rate on corporate taxable income (cf., 20% on dividends).
2) Incentive to finance with debt (since deductible interest reduces net income tax amount).
3) Incentive to retain earnings, not pay dividends (and spend earnings for stock buy-backs).
4) Incentives for corporate tax shelter investments.

Obama Legislative Proposals – 2009 Abandoned in 2010/1

- Eliminate "check-the-box" – at least as to foreign corporations/foreign entities.
- What is the tax policy concern? Possibility of reducing <u>foreign</u> country income tax liability while enabling U.S. income tax deferral of the E&P retained in foreign subsidiary (i.e., CFC).
- Is legislation necessary? Check-the-box was adopted by regulation (not a Code provision).
- Revoke by administrative action?

Simpson-Bowles Fiscal Responsibility Commission

P. 50. Proposing a reduction of corporate tax rate.

Eliminate special business subsidies, i.e. fast depreciation deductions.

How deal with multinationals? Use a territorial system?

Already in effect – note Apple's (non) tax liability?

Tax Cuts and Jobs Act - 2017

- Corporate tax rate reduced (by 40 percent) from 35 percent to 21 percent.