FALL 06

LESSON **1**

Introductory/ Definition of "Corporation"

(1) The purpose of the initial questions is to let the students start with what they should know (general business organization options under state law and basic income tax) and begin to integrate that knowledge into the process of learning throughout this course what they do not know about the complexities of the corporate income tax. The tax options are, of course, conduit entity or separately taxed entity; that is, partnership taxation (subchapter K) or S corporation taxation, versus C corporation taxation.

It is useful to have the students see the lay of the land from the start by explaining in general terms the occasions for use of the C corporation and the fact that many of its governing tax rules also apply to S corporations. There may not be a free choice between conduit and C corporation taxation because publicly traded partnerships that conduct active businesses generally will be treated as C corporations, as discussed below. Likewise, there may not be a free choice between S corporation status and C corporation status, because of the 75-shareholder limit (and other eligibility requirements) for S corporations. Therefore, if the venture is to be a publicly traded active business, it will have to be taxed as a C corporation. If it is not publicly traded, it may be able to qualify as either a C corporation or a conduit entity, and, if the latter, then all the state law forms of operation can be used: general or limited partnership, limited liability company, or corporation (making an S election). Generally, the size of the entity's capital is irrelevant to the tax classification, but the tax options can depend in various ways on the number of owners.

If the facts permit a choice, the investors' choice between conduit status and C corporation status involves various considerations, including the following: (1) The current tax rate relationship between individuals and C corporations generally means there can be more after-tax dollars accumulated by a C corporation that does not pay dividends, after compounding of earnings over time, than dollars in the hands of (or available without further tax to) owners of S corporations or partnerships having the same incomes; (2) distribution of those earnings from the C corporation will incur a second tier of tax (though reduced to a top rate of only 15 percent by 2003 legislation),

and the tax law (or the practical needs of the shareholders) may force such distributions; (3) the conduit entities retain the ability to enjoy through their owners the 15 percent (or lower) capital gains rate on their own gains, whereas the C corporation pays the much higher corporate rates on its capital gains (i.e., there is no preferential rate for corporate capital gains); (4) entity losses may provide immediate tax benefit only to owners of a conduit entity, subject to their basis in the entity interest and to limitations on passive losses; (5) if entity earnings do not have to be distributed as dividends and the owners can sell the entity at a preferential capital gains rate or can die and provide their heirs with a stepped-up basis in the entity, perhaps the two-tier taxation of C corporation earnings may be partly avoided; (6) 2003 legislation taxing dividends at the same rate as capital gains (a top rate of 15 percent) materially reduces the double tax impact for C corporations; and (7) the rules regarding the state law mechanisms and tax treatment of important corporate transactions such as mergers and other acquisitions, redemptions, liquidations, and divisions are generally simpler and often more favorable than the sometimes rudimentary rules governing partnerships and limited liability companies.

Caution the students that if this analysis is confusing, it should be, because its refinement and amplification is in large part the end result (as opposed to the beginning) of the entire course. It can be useful, however, to attempt to give the students the "big picture" at the outset, so they will have an idea what to look for. A more detailed comparison of the taxation of various entities will occur in Lesson 2.

(2) Classification of entities: Whereas question (1) focuses on the basic taxing regimes, question (2) focuses on the basic business forms with which the students may be familiar, and attempts to integrate the two. Discuss the development of law from the *Morrissey* resemblance test to the mechanical equal weighting test of the prior regulations, to the check the box rules of Regs. §§ 301.7701-1, 301.7701-2, 301.7701-3, and 301.7701-4 (which can be discussed here). Of course (a) necessarily will be treated as a corporation, while (b), (c), (d), and (e) will be treated as partnerships unless they elect to be treated as a corporation (unless they have publicly traded equity and § 7704 requires them to be treated as a C corporation).

(3) This question simply introduces the student to the somewhat novel idea that a state law something can be a tax nothing, or a disregarded entity (DE), under Regs. § 301.7701-3(b)(1)(ii). Thus, the LLC will be treated as a division of *X* for federal income tax purposes. This means, for example, that sales between *X* and the LLC do

not result in income realization or a new cost basis and that distributions from the LLC are not dividends or other income to *X*.

(4) This question is designed to impress on the students the need for the corporation to act as an entity if the shareholders want it to be treated as a separate taxpayer. *Moline Properties* stands for the proposition that a corporation will not be ignored, or treated as the agent of its owners, so long as it actually carries on a business activity. But sloppy practices, as occurred in *Roubik*, can result in the shareholders being treated as the direct owners of the business and its income, which could occur on the facts here. The Service may have little motivation to disregard the "form" asserted by the corporation here because it can result in application of the two-tier tax regime to the corporation and its shareholders, if the "salary" is disregarded as a sham and taxed as a dividend (though taxable at the lower capital gains rate since 2003).

(5) Discuss the earlier view of government that professional service corporations should not "enjoy" benefits of corporate status (e.g., previously more generous tax-deferred compensation plans) and judicial rejection of the government's view and subsequent demise of most of the preferential treatment of corporate benefits. State law characterization under normal professional corporation statutes now controls the tax characterization. Rev. Rul. 70-101. But attempts to milk all of the corporation's income out to the professionals in the proportion of their stock ownership still may fail and the income may be treated as dividends (though taxable at the top rate of only 15 percent since 2003).

Additional possible considerations: Discuss other attacks on personal service corporations and their proprietor/shareholders: (1) assignment of income (*Roubik*); (2) § 482 (*Fogelsong*); (3) personal holding company (Rev. Rul. 75-67); (4) accumulated earnings tax (*Booth*); (5) § 269A, which can apply in the *Keller* fact patterns; (6) § 269; (7) § 11(b)(2) (loss of lower brackets); and (8) § 162(a) (unreasonable compensation). B&E ¶¶ 1.05, 2.06, 2.07.

(6) *A-B* wants to be treated as the project owner in order to pass-through losses and get other benefits of partnership status. *X* is normally treated as an agent and not the principal owning the project where *X* is owned by unrelated parties.

Alternative: Where *X* is controlled by the partners, the rulings of *Moline Properties* (if a corporation has any business activity at all, it will be treated as a separate taxable

entity) and *National Carbide* (which seemed to render it almost impossible for a controlled corporation to be an agent) produced confused answers until *Bollinger* clearly made permissible *X*'s agency status here, at least when the three-pronged test of that decision is met. Discuss the possibility of agency status when said test is not met. B&E ¶¶ 1.05, 2.10.