LESSON 2

The Corporation Income Tax

2A Overview; Stakes and Comparison of S Corporation Regime

SUBJECT: Comparison of various taxing regimes in the Code—Application of the corporate tax rate—Consideration of the advisability of an S election

ASSIGNMENT

B&E: ¶¶ 1.02, 1.03, 1.04, 1.07, 5.01–5.03[1], 5.09, 6.01, 6.02, 6.06, 6.08, 6.11, 7.01

Code: §§ 1(a)–1(e), 1(h), 11, 162(a)(1), 701, 702, 1014, 1201(a), 1211(a), 1361(a), 1361(b)(1), 1361(b)(2), 1363(a), 1363(b), 1366(a), 1366(b), 1366(d)(1), 1367(a), 1371(a)

PROBLEMS

(1) *Focus on the short term:* If *A*, an entertainer, were averaging $1 million a year of taxable income from his business, would you advise *A* to incorporate as a device to save taxes? Would you advise *A* to make an S election for the corporation? To help you answer these questions, compare the net after-tax cash *A* would have after a full year (a) as a sole proprietor, (b) as the shareholder and only employee of an S corporation that pays him a $1 million salary, or (c) as the shareholder and only employee of a C corporation that pays him all of its after-tax income as salary. Would he do better if he used a C corporation that paid him a $500,000 salary and he either received the maximum possible dividend or sold the stock the next year? What would result if he took a $500,000 salary from his S corporation and sold the stock the next year?

(2) *Focus on the longer term:* *A* wants to organize a manufacturing business that will generate $1 million in taxable income per year without any reinvestment of income. After-tax income can also earn 10 percent in the second and third years by being reinvested in the business (in capital equipment, so there will be no accumulated earnings tax for a C corporation problem if dividends are

not paid). Calculate the aggregate after-tax income of the business at the end of the third year, assuming first that the business operates as an S corporation or a limited liability company (here, the calculation will be at *A*'s level) and second that the business operates as a C corporation (here, the calculation will be at the corporation's level; assume no dividends). Does your calculation mean that the business should operate as a C corporation? Would your answer change if you assume that *A* sells the business at the end of the third year or dies at the end of Year 3 and leaves the ownership of the business to either *A*'s spouse or *A*'s son?

2B Dividends-Received Deduction; § 1059

SUBJECT: Introduction to multiple corporation tax issues—How the computation of corporate taxable income is affected by intercorporate dividends, which provides a convenient opportunity to introduce the interplay of § 243 with § 1059

ASSIGNMENT

B&E: ¶¶ 5.01, 5.05, 13.02, 13.40, 13.43[3][a]

Code: §§ 11(a), 11(b), 61(a)(3), 61(a)(7), 63(a), 241, 243(a)–243(c), 246(b), 246(c), 246A(a)–246A(b), 1001, 1012, 1059(a)–1059(e)(2), 1211(a), 1222(2), 1501, 1504(a)(1), 1504(a)(2), 1561(a), 1563(a)

PROBLEMS

(1) *X* is a publicly held corporation with a subsidiary, *S*, of which *X* always has owned 100 percent of the outstanding stock. What is the total tax liability for *X* and *S* under each of the following sets of facts? (In this problem, use all corporate tax rate brackets.)

(a) *X* has taxable income of $2.2 million and *S* has no income.

(b) *X* has taxable income of $2 million and *S* has taxable income of $200,000.

(c) Same as (b) above, but *S* distributed $100,000 to *X* as a dividend.

(d) Same as (c) above, but *X* has not always owned all of the stock of *S*, and the dividend is distributed out of earnings and profits of a taxable year of *S* during which *S* and *X* were not members of the same affiliated group.

(e) Same as (c) above, but *X* owns only 10 percent of the vote and value of *S*'s stock at all times during the year.

(f) Same as (c) above, but *X* and *S* file a consolidated return.

(2) *Y* learns that *X* (a large public company) will pay a large dividend, and so, before the record date, *Y* buys one share of *X* for $100, receives a $50 dividend 20 days later and sells the stock for $50 the next day. What is *Y*'s taxable income from the dividend and the stock sale?

Alternative: *Y* buys all the stock of *X* for $100 and causes *X* to pay a $50 dividend 10 days later and sells the stock for $50 six months later.