

LESSON 2

The Corporation Income Tax

2A Overview; Stakes and Comparison of S Corporation Regime

(1) First, as a sole proprietor, *A* will pay \$350,000 in tax and have \$650,000 left. Second, as a C corporation (or S corporation) paying out all net earnings as salary, the corporation will pay no income tax and thus theoretically could pay out the entire \$1 million (disregarding employment taxes and local taxes), in which case *A* again will net \$650,000. This, however, may not be possible or desirable, and part of such salary could be recharacterized as a dividend (but since 2003, taxation as a dividend is only 15 percent). Third, if \$500,000 is paid to *A* as salary, then *A* will net \$325,000 on \$500,000 income and the corporation will net \$325,000 on \$500,000 income (note that because this is a personal service corporation, the lower brackets are not available under § 11(b)(2)). *A* can appropriate the retained earnings of \$325,000 to his personal use by a dividend from which *A* will net \$275,000, for a total net to *A* of \$600,000, or by a sale of the stock, in which we assume *A* has nominal basis, for \$325,000 resulting in a capital gains tax of \$50,000 and a total net to *A* of \$575,000. Thus, while *A* may be able to approximate his sole proprietorship result by using a C corporation paying out virtually all earnings in salary, any accumulation in *X* coupled with payment of the second-tier tax on that accumulation (even at the lower 15 percent) will result in the short term in a lower net return to *A* than if *A* had used a sole proprietorship. For the longer term, see question (2). B&E ¶¶ 1.02, 1.03, 5.01.

Discuss the lack of capital gain benefit for a C corporation taxpayer, and the limitation of use of capital losses. B&E ¶ 5.01.

An S election avoids double taxation of accumulated income and concern about having to pay salary equal to net earnings. Briefly discuss the following:

1. Eligibility for S election (§§ 1361(a) and 1361(b)).
2. Computation but nontaxability (normally) of income at the corporate level (§§ 1363(a) and 1363(b)).
3. Pass-through of income (here, \$1 million) to *A*, if no salary is paid.

Reasonable salary payments will help avoid a surprise assessment of employment taxes (§§ 1366(a) and 1366(b)) based on recharacterization of distributions as salary. Rev. Rul. 74-44, 1974-1 CB 287.

4. Limitation on loss pass-through to basis in stock and debt (§ 1366(d)(1)).
5. Increase in stock basis for S corporation income and decrease for distribution that is not included in shareholder's gross income. Here, if \$1 million is distributed, then there is no change in stock basis whether the \$1 million is paid as salary or on account of stock held; if \$500,000 is paid as salary and \$500,000 is retained, then \$350,000 of tax is paid by A on the entire \$1 million—half as salary and half as pass-through income—and there is \$500,000 additional basis in stock, so that the remaining \$500,000 may be distributed without additional tax (§§ 1367(a), 1367(b), 1368(a), and 1368(b)).
6. Fact that otherwise subchapter C rules apply (§ 1371(a)). B&E ¶¶ 6.01, 6.02, 6.06, 6.09).

(2) This question is intended to address more specifically some of the issues raised generally in the first question of Lesson 1. Adding the net reinvestment income to the annual \$1 million income and applying the 35 percent tax rate (applicable since 2003 to both corporations and individuals) to determine after-tax income and adding those sums for the three years yields \$2,079,497 for the S election or limited liability company and the same amount, \$2,079,497, for the C corporation. The lack of any spread occurs because of the fortuitous congruence of individual and corporate tax rates since 2003 (assuming no change in return and taxes, a perilous assumption). This comparison suggests that no advantage arises under current (2003) rates from using the C corporation if corporate income is accumulated; prior to 1986 legislation, however, there was a substantial rate arbitrage benefit from accumulating income in a C corporation (though that advantage disappeared totally in 2003).

However, a sale raises the offsetting prospect of paying a second tier of tax on the accumulated business income if the C corporation is used; no second tier of tax will be paid on the three years' income if a conduit entity is used, because A's basis in the entity interest will have increased by the amount of the entity's retained income. We do not address here the issue of unrealized appreciation inside the corporation, which raises the *GU* problem to be discussed in Chapters 8 and 10.

If the heir is a spouse and no estate tax is due because of the marital deduction, the spouse will take a fair market value § 1014 basis in the business interest and can sell the business with no further income. If the heir is a child, a substantial estate tax may be due, although the § 1014 basis rule still will apply. Of course, the estate tax would be due on A's total net worth whether the business is incorporated in a C corporation or S corporation or is in a limited liability company or is unincorporated.

Again caution the students that there is no easy answer to the question of whether to use the C corporation, and more learning is to come on that subject. B&E ¶¶ 1.02, 1.03, 5.01[5]. A wise teacher today should probably skip this question altogether if he or she wants to retain any students in the class.

2B Dividends-Received Deduction; § 1059

Note that the corporate AMT can be discussed here, but it is not covered in the problems or assigned, nor is it advisable to do so.

(1)(a) \$748,000 tax on X.

(1)(b) \$680,000 tax on X and \$68,000 tax on S. Discuss phase-out of lower brackets. Assume the corporations consent to an apportionment plan giving 100 percent of the lower bracket benefit to S under § 1561(a)(1) and flush language following. The penultimate sentence of same subsection is intended to direct that the entire \$11,750 benefit should be recaptured from S. B&E ¶¶ 5.01[1], 13.02[2].

(1)(c) Same answer as (1)(b). This is a qualifying dividend under § 243(b); thus, X has a \$100,000 deduction. B&E ¶ 5.05[2].

(1)(d) \$68,000 tax on S; \$686,800 tax on \$2,020,000 taxable income of X. 80 percent DRD applies. B&E ¶ 5.05[1]; § 243(c). [Although AMT normally would include 75 percent of the \$80,000 E&P that was not included in taxable income, § 56(e)(4)(C)(ii) permits 80 percent and 100 percent DRD for AMT purposes.]

(1)(e) \$61,250 tax on S because X and S no longer are a controlled group; \$690,200 normal tax on \$2,030,000 taxable income of X, if 10 percent of S's stock is owned by X. [However, AMT does not allow 70 percent DRD, so 75 percent of the \$70,000 is

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subject to AMT. No AMT results, however, because 20 percent times (\$2,030,000 + \$52,500) equals \$416,500, which is less than the normal § 11 tax (the exemption amount is phased out). B&E ¶ 5.08.]

(1)(f) \$748,000 tax on group of *X* and *S*. Explain briefly that dividends within electing affiliated group are eliminated. B&E ¶ 13.43[3][a].

(2) *Y* paid \$100 for the stock of *X* and winds up with \$100 after disposing of the stock, not taking into account tax results. Loss on the \$50 sale would not offset the dividend income because of § 1211(a), but if *Y* has \$50 of capital gains, the loss is worth \$17.50 to *Y* in tax savings. Although the dividend appears to cost *Y* only \$5.25 if the 70 percent DRD applies, the DRD does not apply, because of § 246(c)(1)(A). B&E ¶ 5.05[7]. Therefore, the dividend is fully taxed, and the transactions produce no net tax gain or loss to *Y*.

Alternative: Section 1059 applies. It is a difficult provision and should be explained first. The dividend is an "extraordinary dividend" because (1) it is received by a corporation within two years of the stock acquisition; (2) it is greater in amount than the threshold percentage of the stock basis; (3) the stock was not held during the entire period of *X*'s existence; and (4) it is not a qualifying dividend. Therefore, the nontaxed portion of the dividend (80 percent, or \$40) reduces the stock basis to \$60 so that the stock's sale for \$50 yields a \$10 loss, which is equal to the \$10 taxable income from the \$50 dividend. B&E ¶ 5.05[8]. Note that 2003 legislation, in lowering the tax rate on dividends to 15 percent for individuals, (1) imposed and expanded the § 246(c) holding period in § 1(h)(11)(B)(iii) in order to qualify for the reduced rate, and (2) extended the § 1059 extraordinary dividend rules to individuals as well in § 1(h)(11)(D)(ii) (any loss on a later sale of the stock is treated as long-term capital loss).