Corporations
Zoom Webinar on December 12, 2020

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Goal for today’s webinar

Discuss most commonly tested corporation areas

Review selected prior exam questions

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CORPORATE TAX ISSUES

Are often tested on the exam

They may be high point questions – making the calculations, or describing the theory - it’s best to have some idea of how to deal with corporate formation and liquidation problems

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CORPORATIONS

Business entities created under state law

Unlimited life and survive the death of principals

Limited liability – subject to limitations

C vs S CORPS

C corp is a separate taxable entity that pays tax on income at the corporate rate.

S corporation is a pass-through entity - under certain circumstances it may be taxed.

CAPITAL CONTRIBUTION

Generally not taxable to corporation

Under §351, if one or more persons transfer money or property to a corporation solely for corporate stock, and immediately after the exchange the transferor(s) control 80% of the voting/nonvoting shares, there is no gain or loss to transferor or transferee.

ASSUMPTION OF LIABILITIES

Under §357, assumption of liabilities in a §351 transfer generally does not mean gain to the transferor unless the corporation assumes liabilities in excess of the transferor's adjusted basis, or if there is no good business reason for the transfer.

ASSUMPTION OF LIABILITIES EXAMPLE

Ted and Sue form a corp. Sue contributes her computer with a FMV of $3,000, basis of $0 (§179 was used when it was purchased by her sole proprietorship), and debt of $2,000. Ted contributes $3,000 in cash.

Sue recognizes $2,000 worth of gain due to the debt relief exceeding her basis ($2,000 – 0).

BASIS PROPERTY CONTRIBUTED

If S/H contributes property under §351, corp takes S/H's basis increased by any gain recognized on the exchange.

If the property is contributed by anyone other than S/H, basis is zero.

BASIS STOCK RECEIVED

Under §351, the stock basis is the adjusted basis of property exchanged:

PLUS any amount treated as a dividend
PLUS recognized gain on the exchange
LESS cash or FMV of any property received
LESS any loss recognized on the exchange and
LESS any liability assumed by the corporation assumes (unless payment of the liability gives rise to a deduction when paid).

LOSS ON CAPITAL CONTRIBUTION

Loss not deductible IF the transferor owns (directly or indirectly) > 50% of the corporation's stock.

Even if TP does not have more than 80% control

DIVIDENDS

E&P distributions are taxable dividends to S/H.

Distributions > E&P are considered a return of capital and not taxable up to the S/H's basis in the stock.

Distributions > stock basis are capital gain to the S/H.

PROPERTY DISTRIBUTION

A corporation recognizes gain/loss when property is distributed to the S/H if the property's FMV > its adjusted basis.

The property is considered to be sold at its FMV to the S/H.

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ACCUMULATED EARNINGS TAX

May apply to C corp for not distributing earnings beyond its reasonable business needs under §532 - 15% tax is on accumulated taxable income.

Corp may retain E&P profits to meet reasonable business needs including:

- expansion of the business
- replacement of plant or equipment
- retirement of debt

Corps permitted generally to accumulate $250K

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STOCK REDEMPTION

Corp buys stock back from a S/H using corporate funds. Redemption can be used to buy out an existing S/H - unlike a complete liquidation, corp continues to exist after a stock redemption.

A stock redemption is classified as a fully taxable dividend if certain factors are present - a stock redemption is treated as a sale of stock by the S/H with gains eligible for the favorable capital gain tax rates.

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STOCK REDEMPTION

The types of transactions that qualify as stock redemptions and capital gains treatment at the S/H level include:

- The distribution is not essentially equivalent to a dividend: the transaction creates a meaningful reduction in the S/H's interest in the corporation.
- Substantially disproportionate redemption of stock: The S/H must (after the distribution) hold < 50% of voting stock and < 80% of the interest S/H held before the redemption.

STOCK REDEMPTION

The types of transactions that qualify as stock redemptions and capital gains treatment at the S/H level include:

- Termination of a S/H's interest: complete termination of the interest is treated as a stock redemption.
- Partial liquidation: if the distribution is in redemption of stock held by a noncorporate S/H and in partial liquidation of the distributing corporation. The distribution is generally pursuant to a plan of liquidation.

CORPORATE LIQUIDATION

C and S liquidations governed by §331 and §336.

Each entity has taxable income on the difference between the FMV and Basis of assets at liquidations:

CORPORATE LIQUIDATION

under §331 the amounts received by S/H in complete liquidation of a corp are treated as in-full payment in exchange for the stock. If property is distributed its FMV is used to determine gain or loss on the transaction

If the stock basis is > the total distribution (cash and property), the S/H recognizes a loss.

If the distribution is > stock basis, S/H recognizes a gain.

CORPORATE LIQUIDATION

under §336 a gain or loss will be recognized to a liquidating C or S corp on the distribution of property in complete liquidation as if the property were sold to the distributee at its FMV.

S CORPORATIONS

tax issue - some pass-through advantages of a pship with liability protection - conduit and not a tax paying entity, except:

- tax may be due on any recognized BIG.

If previously a C corp, it pays tax on excess of value of the S corp's assets at the beginning of the first year for which the S election is in effect over the adjusted basis of the assets – during first 10 years if S election before 2009, 7 years for 2009 and 2010, and 5 years now

S CORPORATIONS

If the S corp has E&P from when it was a C corp, and its passive income > 25% of gross receipts, it must pay corp tax on the 'excess net passive income.'

If the situation continues for 3 years, the S election is revoked.

S CORP PASSTHRU TO S/H

Items of income, deduction or credit that might affect a S/H are separately stated and each S/H takes a prorata share of the item.

Remaining non-separately computed income is taken into account by S/H on a prorata basis.

The item's character before the pass-through is retained at S/H level.

S/H BASIS

S/H must have basis to deduct losses.

Basis is the original capital contribution:

- + corp income taxable to S/H, <u>and</u>
- - nontaxable distributions and by items of loss and deductions allocated to S/H.

S/H BASIS/LOANS

If items reduce basis to zero S/H can continue to deduct items and reduce basis for any debts owed by the corp to S/H.

If S/H does this and later corporate income increases the stock basis, the basis of debt is increased back to the original level.

S/H guarantee of a loan does not give additional basis to deduct corp losses until S/H actually makes payment on guarantee. Then payment is treated as a direct loan to the corp.

S CORP REQUIREMENTS

S/H must elect S status within the statutory period (generally on or before the 15th day of the 3rd month of tax year in which the S election is desired) and

- no more than 100 S/H allowed (individuals, estates or qualified trusts) – S/H must consent,
- family members can elect to be treated as 1 S/H,
- only 1 class of stock is permitted,
- no NRA permitted, and
- a calendar tax filing year is required.

S CORP DISTRIBUTION RULES

Example: Seashore Shells is an S corp with no E&P. It distributes $75,000 to its only S/H, Sue. Sue's adjusted basis in the stock is $55K.

The amount of the distribution > her basis ($20K) is taxable as a gain from the sale or exchange of property.

S CORP DISTRIBUTION RULES

Under the S corp distribution ordering rules: most distributions tax-free except:

- if > basis, treated as a capital gain.
- if the S corp has E&P from when it was a C corp, may be taxable as dividends, and
- dividends in excess of AAA (accumulated adjustments account) are taxed as dividends to the extent of E&P

S CORP DISTRIBUTION RULES

Example: Raggedy Reef is a C corp that converts to an S corp on 1/1/A6. It has E&P of $50,000 on that date. In 20A6 the corporation has ordinary income of $10,000 and distributes $50,000 to its S/Hs.

	AAA	E&P
Balance at 1/1/A6	$ 0	$50,000
Ordinary income	10,000	0
Distribution	(10,000)	(40,000)
Ending balance	$ 0	$ 10,000

The $40K distribution is taxable as a dividend.

2018/S-17 (5 minutes)

Briefly describe the circumstances under which a transfer or transfers to a corporation in exchange for stock of such corporation will be entitled to nonrecognition treatment. Also describe relevant adjusted basis rules.

2018/S-17 (5 minutes)

SUGGESTED ANSWER: To qualify for non-recognition of gain or loss, a person or group of persons must exchange property for stock and have control of the corporation immediately after the exchange. Control is 80% or more of total shares and voting power. The transferor recognizes gain only to the extent of boot received.

The transferor's basis in the stock is the adjusted basis of the property given up plus any gain recognized by the transferor.

The corporation's basis in the property is the adjusted basis of the property in the hands of the transferor plus any gain recognized by the transferor. (10/10)

2018/S-20 (3 minutes)

TP1 and TP2 discussed in great detail a prospective business opportunity in which they would be participants. TP1 decided to loan money to TP2, but only if TP2 gave TP1 an interest in the business, TPI sent $30,000 to TP2, and together they formed a corporation under the laws of the nation of Belize (Corporation) in which TP1 and TP2 were equal shareholders. Over a 16-year period, TP1 made advances to Corporation totaling in excess of $11,000,000. Each TP advanced money, TP1 did so without setting a time for repayment and without prescribing a rate of interest on the advance. At the time of the Tax Court trial, TP1 had received no repayment of any advance and had received no interest. When Corporation obtained loans from independent lenders over the years, it signed formal written loan documents and repaid the lenders. TP1 did not obtain formal loan documents for any of these advances. TP1 claimed bad debt deductions in 2010 and 2011 with respect to the advances to Corporation. Discuss whether TP1's advances should be characterized for income tax purposes as debt owed by Corporation to TP1 or as contributions to the capital of Corporation by TP1.

2018/S-20 (3 minutes)

SUGGESTED ANSWER: The advances should be characterized as capital contributions. There were no notes signed, no agreements or repayment terms and other borrowings were documented and paid as a matter of course. (6/6)

NOTE: Case is *Michael J. Burke and Jane S. Burke* **(TC Memo 2018-18 (2/21/18))**

2016/S-29 (12 minutes)

The taxable year is 2016, during which Tippet Corporation, a calendar year taxpayer, has §316 current earnings and profits from operations of $150,000. As of December 31, 2015, Tippet Corporation had §316 accumulated earnings and profits of $500,000. The stock of Tippet Corporation is owned equally by A, Inc. ("A"), a corporation, and TP, an individual. TP's adjusted basis in TP's 2,000 shares of stock of Tippet Corporation is $300,000. A's adjusted basis in its 2,000 shares of stock of Tippet Corporation is $600,000.

2016/S-29 (12 minutes)

On December 31, 2016, Tippet Corporation makes the following nonliquidating distributions that are characterized as dividends for state law purposes:

Distributee Shareholder	Property Received	Fair Market Value	Adjusted Basis to Tippet Corporation
TP	Cash	$500,000	$500,000
TP	Grizzly Corporation stock*	$300,000	$50,000
A	Cash	$500,000	$500,000
A	Inventory	$300,000	$350,000

*** Stock of Grizzly Corporation, an unrelated corporation, acquired in 2005 by Tippet Corporation as an investment.**

2016/S-29 part 1 (4 minutes)

Discuss and quantify the gain and loss recognition consequences to Tippet Corporation that result from the 2016 distributions.

SUGGESTED ANSWER:

§315 AE&P, §301 distribution

Accumulated E&P
$150K current
$500K accumulated
$650K E&P
$250K gain (stock FMV $300K - $50K basis)
$900K

Basis: A $600K, TP $700K

Distribution: A $800K, TP $800K

2016/S-29 part 1 (4 minutes)

Discuss and quantify the gain and loss recognition consequences to Tippet Corporation that result from the 2016 distributions.

	CORP A	INDIV TP
Basis	$600K	$300K
AE&P	$450K	$450K
Distribution	$800K	$800K

SUGGESTED ANSWER: Cash distributed has no tax consequences to Tippet Corp as an unappreciated asset.

Grizzly stock is taxed at LTCG for Grizzly Stock's appreciated value to Tippet Corp.

Inventory that decreases in value is not a deduction nor is it taxable to Tippet Corp. (8/8)

2016/S-29 part 2 (4 minutes)

Determine the §301 consequences to TP of the 2016 distributions from Tippet Corporation, and determine TP's adjusted basis in the stock of Grizzly Corporation.

SUGGESTED ANSWER:

Received cash of $500K and stock of $300K = $800K.

E&P allocated to TP $900,000/2 =$450K

The first $450,000 received is a taxable dividend.

$800K-$450K=$350K

The next $300,000 received is a nontaxable return of capital.

$350K-$300K = $50,000

The remaining $50,000 is a capital gain distribution in excess.

2016/S-29 part 2 (4 minutes)

Determine the §301 consequences to TP of the 2016 distributions from Tippet Corporation, and determine TP's adjusted basis in the stock of Grizzly Corporation.

SUGGESTED ANSWER:

TP $450K distribution of AE&P up to stock basis is a dividend

$300K distribution of basis is a return of capital (no tax)

$ 50K distribution in excess of basis is LTCG

$800K distribution

Stock basis in Grizzly Corp is $300,000. (8/8)

2012/S-19 (11 minutes)

On January 1, 2012, A, B, and C organize ABC Corporation (which is not and will not be an "investment company" under §351(e)). The following transfers were made to the corporation:

Transferor	Property	Fair Market Value	Adj Basis to Transferor
A	Cash	$200,000	$200,000
B	Equipment	$300,000	$300,000
C	Unimproved real property	$520,000	$100,000

2012/S-19 (11 minutes)

B's equipment had been purchased in 2010 for use in B's trade or business at a cost of $400,000, and because of depreciation, the adjusted basis had been reduced to $300,000 on January 1, 2012. The unimproved real property had been held by C as an investment since C's acquisition of the property in 2000.

2012/S-19 (11 minutes)

In exchange for the contributions of A, B, and C. the corporation issues its common stock, 200 shares to A, 300 to B, and 500 shares to C. The fair market value of the stock is $1.000 per share; the common stock is the only class of stock authorized and outstanding. In addition to the 500 shares of stock, C receives from ABC Corporation $5,000 of cash and a 1-year note of ABC Corporation in the amount of $15,000 at 6% interest. The ABC note has a fair market value equal to the face amount of the note.

2012/S-19 part 1 (4 minutes)

(a) (4 minutes) Determine C's gain realized, C's gain recognized, and the character of any gain recognized by C.

SUGGESTED ANSWER: FMV $520K – Basis $100K = $420K Gain Realized. Cash $5K + Note $15K = $20K.

Gain is recognized to the extent of boot received so $20K is LTCG (8/8)

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2012/S-19 part 2 (3 minutes)

(b) (3 minutes) Determine C's adjusted basis in the ABC Corporation stock received.

SUGGESTED ANSWER: $100K

ALTERNATE ANSWER: Under §358(a)(1), the basis of C's stock would be the basis of the contributed property ($100,000), less the value of the note received ($15,000) and the cash received ($5,000), plus the gain recognized upon transfer ($20,000), or $100,000.

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2012/S-19 part 3 (2 minutes)

(c) (2 minutes) Determine the amount of gain recognized by ABC Corporation.

SUGGESTED ANSWER: None (4/4)

NOTE: no gain on the §351 transfer

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2012/S-19 part 4 (2 minutes)

(d) (2 minutes) Determine the adjusted basis of ABC Corporation in the real property received from C.

SUGGESTED ANSWER: 100,000 + 20,000 = $120,000 (4/4)

You CAN do this!

We're here to help you!

Questions & Answers

Let's take as many as we can