UNDERSTANDING CORPORATE TAXATION

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Chapter 1

INTRODUCTION TO CORPORATE TAXATION AND ITS "DOUBLE TAX" SYSTEM

§ 1.01 Introduction to the "Corporate Tax" and Resulting Double Taxation

A "corporation" is a legal entity created under a state or other statute that allows "incorporation" by persons who become the "shareholders" of the corporation. In general, the corporation's organizers complete appropriate forms and file them with the state (or other jurisdiction) in which the corporation will be incorporated. Those organizers become the corporation's initial shareholders once the corporation is recognized by the state. Corporate shareholders may be individuals, other corporations, or other entities such as partnerships. In general, an entity recognized as a corporation under state law is also treated as a corporation for federal tax purposes.

For tax purposes, a corporation is a separate "taxpayer"[1] from its shareholders, meaning that the corporate entity is subject to taxation on corporate-level events. Section 11 of the Internal Revenue Code (Code) lists the progressive rates of tax on corporations. In addition, shareholders must pay tax on dividends received, *see* I.R.C. § 61(a)(7), and the dividends paid are not deductible although payment of the corporate tax reduces the amount the corporation has available to distribute to shareholders.[2] This "double taxation" of profits— once at the corporate level and then again on distribution to shareholders— is a hallmark of the corporate tax regime.

Example 1.1: X Corporation is owned equally by Abby and Ben, unrelated individuals. They each have a basis of $250 in their X Corporation stock. In Year 1, the only tax-significant events are that X Corporation earns $10,000 of ordinary income and it distributes $100 to each shareholder. X Corporation will pay tax on the $10,000 under rates determined under Code section 11. In addition, Abby and Ben will each have $100 of dividend income.

Double taxation of business is not mandatory. Businesses conducted as sole proprietorships, partnerships, limited liability companies, or small

[1] "The term 'taxpayer' means any person subject to any internal revenue tax." I.R.C. § 7701(a)(14).

[2] Of course, shareholder-level tax is not imposed on corporate funds used to pay the corporate income tax; it is only imposed on amounts distributed as dividends. *See* I.R.C. § 61(a)(7); Jeffrey L. Kwall, "The Uncertain Case Against the Double Taxation of Corporate Income," 68 *N.C. L. Rev.* 613, 631 (1990).

corporations taxed under Subchapter S of the Code are generally subject to only one level of tax.[3]

> *Example 1.2*: Assume that in Example 1.1, X Corporation had elected to be taxed under Subchapter S. As in Example 1.1, in Year 1, the only tax-significant events are that X Corporation earns $10,000 of ordinary income and it distributes $100 to each shareholder. Abby and Ben will each have $5,000 of ordinary income (half of $10,000) and will each reduce their stock bases by $100.

Comparing Examples 1.1 and 1.2 indicates that, in the aggregate, Example 1.1 resulted in $200 more gross income than Example 1.2. That is, the dividend distributions were essentially taxed twice in Example 1.1. In general, therefore, profitable businesses run by corporations other than those taxed under Subchapter S (that is, C corporations, I.R.C. § 1361(a)(2)) occasion the imposition of more federal income tax than other businesses, at least to the extent that they distribute their profits.[4] From an economic perspective, it is not clear to what extent shareholders bear the incidence of the corporate tax, and to what extent it is borne by the employees, creditors, or customers of the corporation.

There are a number of ways in which Subchapter C corporations may try to minimize double taxation, such as treating distributions to shareholders as deductible payments of salary or as deductible interest on loans, or simply retaining earnings. As discussed in section 1.02, there are limits to the effectiveness of any of these devices. There is also a movement to eliminate double taxation through "integration" of the corporate-level and shareholder-level taxes. That issue is outlined in section 1.02[E], and is discussed in more detail in Chapter 15.

Why then are so many businesses operated through corporations? There are a number of advantages to the corporate form, though not all of the advantages are unique to corporations. One very important factor is the relative ease of raising capital through the sale of stock. Shares of stock are freely transferable, unlike partnership interests, which generally require the other partners' consent for changes in the composition of the partnership. *See* Arthur R. Pinto & Douglas M. Branson, UNDERSTANDING CORPORATE LAW 6–7 (1999). Because a corporate entity survives transfer of its interests, the price of its shares reflects the present value of future prospects. Multiple classes of stock are possible in a C corporation, so it may be easier to align the structure of the business with underlying interests than it is with a partnership. Also, most publicly traded partnerships will be subject to corporate taxation anyway. *See* I.R.C. § 7704. The corporate form also provides limited liability to investors, as does the limited liability company. Corporations also have centralized management, which is risky for partnerships because partners, unlike shareholders, do

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[3] The tax regime of Subchapter S is discussed in Chapter 8. Note that most publicly traded partnerships are subject to the corporate double tax. *See* I.R.C. § 7704.

[4] In addition, Subchapter S allows the pass through of losses to shareholders. *See* § 8.04[B].

not have limited liability. Centralized management facilitates passive investment, as well. *Id.* at 8.

Some corporations may be organized because lenders require it in order to charge a higher rate of interest that will not violate state usury laws. *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989), discussed in Chapter 2, indicates that this prompted Mr. Lessinger to contribute the assets of his sole proprietorship to a corporation.[5] In addition, historically, some pension vehicles used to be available only to corporations. This disparity was eliminated in 1982, but once incorporated, it is difficult to change to another form of business without undergoing a taxable liquidation.[6] It is also possible for a C corporation to pay less tax than a flow-through entity such as a partnership or S corporation, if the corporation retains most or all of its earnings (so that there are no dividends to tax) and the overall tax rate applicable to the corporation is lower than the rates applicable to its shareholders. However, there is a penalty tax imposed on excessive retained earnings. *See* I.R.C. § 531. The accumulated earnings tax is discussed in Chapter 14.

Corporate shareholders can also be employees, unlike partners in a partnership, so they are eligible for employee fringe benefits that are excludible from income but deductible by the corporation. It is also easier to carry out certain mergers and acquisitions tax-free with a corporation.[7] For all of these reasons, many new businesses are still organized as corporations. Note, however, that not all of these corporations are faced with the problem of double taxation because many smaller corporations make an election under Subchapter S. As discussed below and in Chapter 8, "S corporations" retain many (though not all) of the benefits of the corporate form without the cost of double taxation.

§ 1.02 Avoiding Double Taxation

In order to avoid the double taxation that accompanies the corporate form, corporations may seek to avoid Subchapter C, to retain earnings, or to treat distributions as deductible payments. Particularly in a closely held corporation, many shareholders will also be employees or creditors of the corporation. The corporation may therefore attempt to characterize distributions to shareholders who play other roles in the corporation as payments of salary deductible under Code section 162, rental payments deductible under section 162, or payments of interest deductible under section 163. The IRS generally tries to combat abuses of these approaches by recharacterizing the payments in accordance with their substance.

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[5] *See* § 2.02[A][2][b][ii][II].

[6] Liquidations are discussed in Chapter 7.

[7] Acquisitive reorganizations are discussed in Chapters 9 and 10.

[A] Avoiding the Corporate Form—Partnerships and Limited Liability Companies (LLCs)

In order to avoid the double tax effect that accompanies corporate taxation under Subchapter C, businesses may be organized as partnerships, or as other entities, such as limited liability companies (LLCs). A limited liability company is an unincorporated organization organized under state law. The hallmark of the LLC is limited liability for its investors combined with partnership (one-level) taxation.

[1] A Brief Overview of the Partnership Tax Regime

Partnership taxation is a "flow-through" paradigm under which the partnership is not a taxable entity; partnership-level tax consequences are "passed through" to investors. This "pass-through" or "flow-through" approach results in a single layer of taxation—at the partner level. In order to avoid pass-through of items with particular tax aspects systematically to the particular partners who are most able to use those items for advantageous tax treatment, partnership tax regulations require that the allocation of items among the partners have "substantial economic effect."[8] *See* Treas. Reg. § 1.704-1(b)(2).

[2] LLCs and Other Unincorporated Entities

There are two possible regimes of income taxation generally applicable to LLCs and other unincorporated entities: corporate taxation and partnership taxation.[9] Under current law, unincorporated entities have a choice of regime to adopt, with the default for domestic entities being the partnership tax regime. Those entities did not always have a purely elective choice, however.

[a] A Brief History of the Taxation of Unincorporated Entities

Under federal tax law, "associations" are taxed as corporations. *See* I.R.C. § 7701(a)(3). The test to distinguish an unincorporated entity taxable as a partnership from one treated as an association taxable as a corporation used to occur under the so-called "*Kintner* regulations." *See United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). These regulations were promulgated under section 7701 of the Code, a definitional section that defines both "partnership" and "corporation." *See* I.R.C. § 7701(a)(2), (3).

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[8] A detailed explanation of partnership taxation, which is extremely complex, is beyond the scope of this book. For further reading in this area, see Jerold A. Friedland, UNDERSTANDING PARTNERSHIP AND LLC TAXATION (2000); Laura E. Cunningham and Noël B. Cunningham, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS (2d ed. 2000).

[9] Sole proprietorships are not entities separate from the individuals who own them, so they are not subject to separate taxation.

The *Kintner* regulations adopted the six factors of *Morrisey v. Commissioner*, 296 U.S. 344 (1935). The six factors were (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Treas. Reg. § 1.7701-2(a)(1) (1996). Because the first two of these were common to both partnerships and associations taxable as corporations, the regulations focused on the other four factors. *Id.* In *Larson v. Commissioner*, 66 T.C. 159 (1976), the Tax Court concluded that each of these four characteristics must be given "equal weight."

Under the *Kintner* regulations, an entity with more corporate characteristics than other characteristics was classified as an association taxable as a corporation. In other words, generally speaking, an entity needed three out of four corporate characteristics to be taxed as a corporation; if it lacked even two of the four corporate characteristics, it was taxed as a partnership. The anti-corporation bias reflected a history of desirability of classification as a corporation in order to receive certain tax benefits such as the opportunity to adopt a qualified pension plan, which at one time was available only to corporations. In addition, corporate tax rates used to be lower than rates applicable to individuals, and corporations could avoid double taxation by paying large salaries to shareholder/employees. *See* § 1.02[D][2].

In 1977, a Wyoming state statute authorized LLCs. In 1988, in Revenue Ruling 88-76, 1988-2 C.B. 360, the IRS ruled that entities formed under the Wyoming LLC statute would be treated as partnerships under the *Kintner* regulations. In Revenue Ruling 93-38, 1993 C.B. 38, the IRS considered the proper characterization of two LLCs organized under Delaware law. The IRS characterized one of the LLCs, M, as a partnership, and the other, N, as an association taxable as a corporation, demonstrating that the proper tax classification of an entity organized under a flexible LLC statute depended on the specific provisions of the LLC agreement.

In Revenue Ruling 93-38, M lacked three of the four corporate characteristics. It lacked continuity of life because its LLC agreement provided that, on the death, resignation, expulsion, bankruptcy, or any other event, leading to discontinuance of membership in M, M could continue to operate only with the consent of all the remaining members under M's LLC agreement. M also lacked centralized management because its LLC agreement vested management of M in all of its members. M lacked free transferability of interests because an assignee or transferee of M did not become a substitute member or acquire all the attributes of the member's interest without the consent of all the remaining members. Therefore, although M had limited liability, M was characterized as a partnership because it did not have more corporate characteristics than non-corporate characteristics.

In the same Revenue Ruling, the IRS characterized N as an association taxable as a corporation because N had more corporate characteristics (four) than non-corporate characteristics (zero). The IRS determined that, like M, N had associates and an objective to carry on business and divide the gains therefrom. N also possessed the four corporate characteristics determinative of an association. Similar to M, N possessed the corporate characteristic of limited liability under the regulations. N also provided for continuity of life of the organization because N's LLC agreement stated that N would continue under all circumstances without the approval or consent of any member or manager. Additionally, N's management consisted of three elected managers, according to the terms of its LLC agreement, which resulted in centralized management. Finally, N's LLC agreement allowed for the free transferability of interests. Under N's LLC agreement, an assignee of interest in N became a substitute member and acquired all of the attributes of the member's interest after providing written notice, without the approval or consent by the remaining managers.

[b] The "Check-the-Box" Rules

Following the IRS's approval of partnership tax treatment of many LLCs, the LLC form began to flourish. Currently, every state allows the formation of LLCs. Arthur R. Pinto & Douglas M. Branson, UNDERSTANDING CORPORATE LAW 9 (1999). Effective January 1, 1997, the Treasury moved to an elective "check the box" system for classifying "business entities" for federal tax purposes. *See* Treas. Reg. §§ 301.7701-2, -3.

Under the check-the-box regulations, a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust or subject to other special treatment under the Code. A business entity with two or more "members" is classified as either a corporation or a partnership. A business entity with only one owner is either classified as a corporation or is "disregarded"; if an entity is disregarded, it is treated as a sole proprietorship, branch, or division of the owner. Treas. Reg. § 301.7701-2(a).

Under the check-the-box regulations, certain business entities are taxable as corporations. In general, those entities are (1) those organized under a federal or state statute that refers to the entity as incorporated or as a corporation, body corporate, or body politic; (2) associations, as determined under Treasury Regulation 301.7701-3; (3) those organized as joint-stock companies or joint-stock associations under state law; (4) insurance companies; (5) state-chartered business entities conducting banking activities, if any of their deposits are insured under the Federal Deposit Insurance Act or a similar federal statute; (6) those wholly owned by a state or any political subdivision of a state; (7) those taxable as corporations under a provision of the Internal Revenue Code other than section 7701(a)(3); and (8) certain foreign entities. Treas. Reg. § 301.7701-2(b).

Under the check-the-box regulations, a business entity that is not automatically classified as a corporation can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified as either an association or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3. Unless the entity's members prefer a classification other than the default classification, the entity need not make an election. The default rules generally provide an entity the treatment it probably would have elected; generally speaking, any domestic unincorporated business organization with two or more owners is treated as a partnership for federal tax purposes unless it elects corporate tax treatment. *See id.*

In sum, the check-the-box rules establish the presumptive tax classification of most domestic unincorporated entities as partnerships. They also allow a freely elective regime that avoids any test or analysis of the characteristics of the entity. Thus, for example, both LLCs discussed in Revenue Ruling 93-38 would presumptively be taxed as partnerships under the check-the-box rules even though one of the LLCs had four of the "corporate" characteristics of the *Kintner* regulations.

[B] Avoiding Subchapter C—Introduction to Subchapter S

Subchapter S of the Code allows qualifying electing small business corporations to avoid tax at the corporate level by allocating the taxable income to the shareholders. Subchapter S is thus an elective regime that allows avoidance of the corporate double tax. It is discussed in detail in Chapter 8, and is outlined briefly in this section.

The rules for qualification as an S corporation are intended to be a fairly simple structure, providing for the allocation of a corporation's income and other tax-relevant items to the shareholders, who will take them into account in the tax year in which the S corporation's tax year ends. *See* I.R.C. § 1366(a)(1). Under section 1362(a)(2), all shareholders must consent to make an election under Subchapter S for it to be effective. The main price for this election is the "one class of stock" restriction, discussed below, which precludes S corporations from making allocations based on anything other than the percent of stock each shareholder owns.

There are four requirements that an S corporation must meet in order to be eligible to make an S election. *See* I.R.C. § 1361(b). As discussed below, violation of any of the four requirements by an S corporation results in a prospective revocation of the S election, generally an undesirable result. First, under current law,[10] the corporation must have no more than 75 shareholders. I.R.C. § 1361(b)(1)(A). Husband and wife are treated as one shareholder for this purpose. I.R.C. § 1361(c)(1).

Second, all shareholders must be individuals or certain eligible entities, which are certain estates, trusts, and exempt organizations. *See* I.R.C. § 1361(b)(1)(B). Third, a nonresident alien cannot be a shareholder, I.R.C. § 1361(b)(1)(C), primarily because under the complicated rules governing the

[10] There has always been some limit on the number of shareholders in an S corporation, although that number has increased over time.

taxation of nonresident aliens, the income they receive from S corporations might not be taxed. Subchapter S is intended to eliminate double taxation, but is not intended to allow any corporate income to avoid taxation entirely. Fourth, as indicated above, an S corporation may not have more than one class of stock. I.R.C. § 1361(b)(1)(D). However, voting differences in stock may be disregarded, I.R.C. § 1361(c)(4), and there is a safe harbor to avoid debt being reclassified as equity and thus a second class of stock, I.R.C. § 1361(c)(5).

Code section 1366 governs the "pass-thru" of income and loss to S corporation shareholders. In general, income and loss are passed through to shareholders on a current basis, and, in order to avoid double taxation of shareholders, the shareholder's basis in the S corporation stock is increased to reflect income of the corporation that is included on the shareholder's return. *See* I.R.C. § 1367. The basis is decreased to reflect losses. *See id.* However, deduction of losses is capped at the shareholder's investment in the corporation (the sum of his basis in the corporation's stock and in the debt of the corporation to him).

Example 1.3: Small Corporation is owned equally by Abby and Ben, unrelated individuals. Assume that, at the end of Year 1, Abby has a basis of $50 in her stock and Ben has a basis of $75 in his stock. Assume that in Year 2, the only tax-significant event is that Small Corporation earns $200 of ordinary income. Under Code section 1366, Abby and Ben will each have $100 of ordinary income. Note that they have this gross income despite the lack of any cash distribution that they could use to pay the tax. Abby's basis will increase to $150, and Ben's basis will increase to $175.

Because profits are generally taxed currently to shareholders, taxation of profits distributed would result in double taxation. Therefore, under Code section 1368, to the extent that an S corporation makes a distribution to shareholders of income that was previously taxed to the shareholders, it is not included in income. Under section 1367, the distribution serves to reduce the shareholder's basis in the S corporation shares. In other words, an S corporation shareholder's partial decreased investment in the corporation through distribution of corporate assets reduces that shareholder's basis.

Example 1.4: Assume that for Small Corporation, discussed in Example 1.3, the only event with tax significance in Year 3 is that Abby and Ben cause Small Corporation to distribute $40 to each of them with respect to their stock. There is no tax on the distribution. However, Abby and Ben must each reduce their basis by the amount received. *See* I.R.C. § 1367. Thus, Abby's basis at the end of Year 3 will be $110, and Ben's will be $135.

Those are the general principles of the flow-through paradigm of Subchapter S. Most other transactions involving an S corporation are subject to the same corporate tax treatment discussed throughout the remainder of this book because, under Code section 1371(a), when no special rule applies to an S corporation, the Subchapter C rules apply. Thus, for example, incorporation or liquidation of an S corporation is taxed the same way as incorporation or liquidation of a C corporation, with the proviso that, for the S corporation, all corporate-level tax consequences flow through to the shareholders to be accounted for at that level.

S corporations are also subject to special rules designed to prevent C corporations from avoiding double taxation through opportunistic S elections. Therefore, under Code sections 1374 and 1375, an S corporation that previously was taxed as a C corporation may, in certain circumstances, have a tax imposed on it. More specifically, under Code section 1374, an S corporation that held appreciated assets at the time it converted from C to S status will generally recognize a corporate-level tax at the time it sells those assets. Under section 1375, a corporate-level tax is imposed on an S corporation with accumulated earnings and profits (from its Subchapter C history) when the passive investment income of the corporation exceeds 25 percent of its gross receipts. This tax also prevents a C corporation from avoiding the personal holding company tax discussed in § 14.04.

An S election may be revoked if holders of more than half of the corporation's shares consent to revoke the election. I.R.C. § 1362(d)(1)(B). In addition, an S election terminates if the corporation ceases to qualify as a small business corporation. I.R.C. § 1362(d)(2). Thus, in general, issuance of a second class of stock will terminate an S election, as will transfer of shares in an S corporation to a prohibited shareholder. Terminations, including inadvertent terminations, are discussed in more detail in Chapter 8.[11]

[C] Avoiding Subchapter C—Corporation as Agent

Another way corporate tax treatment theoretically could be avoided would be if the corporation were disregarded as an entity separate from its shareholders. However, in *Moline Properties Corp. v. Commissioner*, 319 U.S. 436 (1943), the United States Supreme Court stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, *so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity*.

Id. at 438–39 (emphasis added).

Subsequently, in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), the Supreme Court considered the possibility that an agency relationship might exist between a corporation and its shareholders so that tax treatment would be determined at the shareholder level, without another layer of tax. The Court set forth a six-factor test for determining when an agency relationship exists, stating:

[11] *See* § 8.03[B].

> (1) Whether the corporation operates in the name and for the account of the principal, (2) binds the principal by its actions, (3) transmits money received to the principal, and (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. . . . (5) [I]ts relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. (6) Its business purpose must be the carrying on of the normal duties of an agent.

Id. at 437 (footnote omitted). In *National Carbide*, the Court rejected the argument that an agency relationship existed. However, in *Commissioner v. Bollinger*, 485 U.S. 340 (1988), the Court revisited the issue on different facts.

In *Bollinger*, real estate developers formed a series of partnerships. Each partnership, in turn, entered into an agreement with a corporation wholly owned by Bollinger. The agreements with the corporations were necessary to secure loans under Kentucky's usury laws, which limited the annual interest rate for non-corporate borrowers. Consequently, the agreements were entered into solely for the purpose of securing financing, and all parties who had contact with the apartment complexes (including lenders, contractors, managers, employees, and tenants) regarded the partnerships as the owners, and knew that the corporation was merely an agent of the partnership. Bollinger personally indemnified and held the corporation harmless from any liability it might sustain as his agent and nominee.

The developers reported their distributive shares of losses from the partnerships on their individual tax returns, even though title to the real properties was held by the corporate nominees. The IRS disallowed the losses on the ground that they were attributable to the corporation as owner of the property. The Tax Court disagreed, and held that the corporations were agents of the partnerships, and therefore should be disregarded for tax purposes. The Court of Appeals for the Sixth Circuit affirmed, and the Supreme Court of the United States affirmed the Sixth Circuit opinion.

In its decision, the Supreme Court "decline[d] to parse the text of *National Carbide* as though that were itself the governing statute." *Id.* at 349. In *Bollinger*, the Court seemed to replace the six-factor *National Carbide* test with a simplified three-factor test, stating:

> It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.

Id. The Court held that the partnerships were the owners of the complexes for federal income tax purposes because the relationships between the partnerships and the corporations were agency relationships, both in form and substance. The Court noted that the corporation had no assets, liabilities, employees, or bank accounts. Furthermore, each written agreement between the partnership and the corporation provided that the corporation "would hold such property as nominee and agent for" the respective partnership. Thus, the corporation was acting as the partnerships' agent with respect to the particular asset acquired, and functioned as an agent and not as a principal with respect to the asset involved. The corporation was not taxed, even though its shareholder, Bollinger, was a partner in the partnerships.

After the Supreme Court decided *Bollinger*, the Tax Court decided *Sundance Ranches, Inc. v. Commissioner*, T.C. Memo. 1988-535, *aff'd*, 1990 U.S. App. LEXIS 19140 (9th Cir. 1990) (unpublished). In that case, the Tax Court rejected the agency argument because, in dealings with third parties, the corporation did not represent itself as merely an agent. The Court of Appeals for the Ninth Circuit affirmed "[s]ubstantially for the reasons set forth by the Tax Court . . . ."

[D] Disguised Dividends

Dividends[12] occasion double taxation. As explained above, a corporation is taxed on its profits, much like any other taxpayer. In addition, those profits are taxed to the shareholder once distributed as dividends. *See* I.R.C. § 61(a)(7). Corporations do not receive a deduction for dividends distributed. Yet, corporations are allowed to deduct certain other payments, notably interest and "reasonable" compensation for services. Shareholders may also be creditors and/or employees of the corporation. Because corporations have a tax incentive to make deductible payments rather than nondeductible ones, there is a tendency for corporations to treat payments to shareholder/creditors and shareholder/employees as interest or salary payments rather than as distributions in the nature of dividends. The IRS naturally tries to combat "abuses" in this area by recharacterizing the payments as distributions to stockholders that may be taxed as dividends.

[1] Introduction to Debt Versus Equity

In general, a corporation can raise capital in two ways: debt (notes, bonds, debentures) and equity (stock). Because interest on debt is deductible by the corporation, *see* I.R.C. § 163(a), whereas dividends paid on stock are not, there is some incentive for a corporation to use debt rather than equity to raise money. Chapter 3 explores the multi-factor test used to distinguish debt from equity and to recharacterize purported debt as equity.

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[12] As discussed in Chapter 4, "dividend" is a term of art that refers to a distribution included in ordinary income under section 316. *See* I.R.C. § 316. Not all distributions with respect to stock are dividends. *See* I.R.C. § 301.

[2] Dividends Disguised as Salary

In closely held corporations where shareholders are also employees, the shareholders may seek to have the corporation distribute its profits in the form of higher salaries and lower (or nonexistent) dividends, in order to allow a corporate-level deduction for amounts paid out. For publicly held corporations, Code section 162(m) generally limits deductibility of salary over $1 million paid to certain employees. There is no such restriction on closely held corporations, but the IRS does have techniques for recharacterizing purported salary as dividend distributions.

In *Charles McCandless Tile Service v. United States*, 422 F.2d 1336 (Ct. Cl. 1970), the taxpayer corporation, McCandless Tile Service, was jointly owned by Charles S. McCandless (father) and Charles L. McCandless (son). The corporation had remarkably high earnings compared to other tile service corporations, but it had neither declared nor paid dividends to its shareholders since its formation in 1960. For the fiscal years 1963, 1964, and 1965, father and son each received $58,500, $79,200, and $86,000 in compensation from the corporation. The IRS disallowed a portion of the corporation's deduction for the compensation payments as exceeding "reasonable" compensation. *See* I.R.C. § 162(a)(1). The IRS argued that the payments were in fact corporate dividends disguised as salary.

The Claims Court (now the Court of Federal Claims) found that, given the language of Code section 162(a)(1), for the corporation to deduct the payments, they must be both "reasonable" and "purely for services." The court noted that determinations of reasonableness are necessarily a case-by-case inquiry, and that courts generally look to factors such as salaries paid by similar enterprises for services of like character, the type and extent of services rendered by the employee, the scarcity of qualified employees for the position, the prior earning capacity of the employee, the peculiar characteristics of the taxpayer's business, and the general economic conditions of the period. However, even reasonable amounts are not deductible to the extent that they are actually distributions of corporate earnings and not true compensation for services rendered.

The Claims Court held that the compensation paid to the two shareholders during the periods in question was within the "realm of reasonableness" given the corporation's remarkable earnings. However, the court disallowed a portion of the deductions because it found that part of the payments were in effect a distribution of corporate earnings disguised as compensation, particularly in light of the fact that the corporation had not declared or paid dividends to its shareholders in any amount since its incorporation. In allocating the corporation's payments to its shareholders between non-deductible dividends and deductible salary payments, the court determined that 15 percent of the net profits (before federal taxes and salaries) represented a reasonable and justified return on equity capital.

[E] Plans for the Future — Introduction to the Integration of Corporate and Shareholder-Level Taxes

The corporate double tax is not a given. At first blush, it may seem that elimination of double taxation would merely require elimination of one of the two layers of corporate tax: the corporate-level tax or the shareholder-level tax. The reality is far more complicated, however. Exempting all dividends or all corporate earnings from taxation would provide ample opportunities for well-advised taxpayers to reduce a single-level tax to no tax at all, as you will see from the transactions discussed in this book.

In 1992, the Treasury Department released a report on corporate tax integration. *See* Treasury Department, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992). The report identified and discussed four possible types of integration of corporate-level and shareholder-level taxes: "dividend exclusion," "shareholder allocation," the Comprehensive Business Income Tax (CBIT), and "imputation credit."[13]

Generally speaking, under the Treasury's dividend-exclusion method, corporate taxes would remain unchanged. However, distributions to shareholders made from earnings taxed at the corporate level would be exempt from tax at the shareholder level. Under the shareholder-allocation prototype, the corporate-level tax would be repealed. All income would be taxed at the shareholder level; the corporation would merely have collection and withholding functions. The CBIT approach would disallow any interest deduction for businesses (corporate or otherwise). In addition, under CBIT, both dividends and interest paid out of earnings taxed at the level of the business would be from exempt from investor-level taxation.

The Treasury's imputation-credit system would keep corporate-level taxes unchanged, but would allow shareholders receiving a dividend a "gross-up" and nonrefundable credit for corporate-level taxes. A few months after the release of the Treasury Report, the American Law Institute (ALI) circulated an ALI Reporter's Study on corporate integration, proposing another imputation-credit method. The ALI's imputation-credit proposal is more elaborate and farther-reaching than the Treasury's proposal.

Thus far, corporate integration is still merely a possibility for the future; the corporate double tax is still alive and kicking. The prospect of corporate tax integration does remain a possibility, and is discussed in further detail in Chapter 15. However, given the fact that certain entities with limited liability (most notably the LLC) can now obtain a single level of taxation, there may be less momentum in the direction of corporate integration than there was at the time of the 1992 Treasury Report.

[13] The 1992 Treasury Report is discussed in more detail in Chapter 15. *See* § 15.02[a][2].

§ 1.03 Distinguishing Capital Gains and Ordinary Income Transactions in Corporate Tax

As you will see in subsequent chapters of this book, many issues in corporate tax involve characterization of a transaction as either a distribution taxable as a dividend on the one hand or as a sale or exchange on the other hand. The characterization of a transaction as a distribution or a sale affects the tax consequences of the transaction particularly because of the differences between "ordinary income" and "capital gains."

[A] "Capital Gains" Versus "Ordinary Income"

Congress has provided for a capital gains preference by taxing certain types of gains differently from other income, so-called "ordinary income," particularly with respect to non-corporate taxpayers.[14] *See* I.R.C. §§ 1(h), 64, 1222. Capital gains are gains from the sale or exchange of a capital asset. The term "capital asset" is defined by exclusion to refer to most personal use and investment property. *See* I.R.C. § 1221(a). The holding period of a capital asset is irrelevant to characterization of a gain as "capital," but, in general, only gains recognized on sale or exchange of assets held for a specified minimum period of time benefit from the capital gains preference.

Capital losses are disfavored in comparison to ordinary losses because there are limits on their deductibility. A corporation can only deduct capital losses from capital gains. I.R.C. § 1211(a). Individuals may offset their capital losses not only against capital gains but also against up to $3,000 of ordinary income. I.R.C. § 1211(b). Code section 1211 disallows a current deduction of excess capital losses but section 1212 permits them to be applied to certain other taxable years.

[B] "Capital Gains" Versus "Ordinary Income" in Corporate Taxation

How is appreciation in the value of stock taxed? As *Eisner v. Macomber*, 252 U.S. 189 (1920), teaches, a "realization event" is a necessary precondition for taxation under our current income tax regime. If a shareholder sells appreciated stock, the difference between the amount of consideration paid for the stock and the shareholder's basis constitutes gain realized. That is, a sale or exchange of appreciated property is taxed only on the profit: the excess, if any, of the amount realized over the shareholder's basis.[15] I.R.C.

[14] Under current law, as a practical matter, there is no corporate capital gains preference. *See* I.R.C. §§ 11(b)(1), 1201. Thus, shareholders other than corporations will particularly value capital gains treatment.

[15] Similarly, a sale or exchange of property that has declined in value will result in a realized loss in the amount by which the seller's basis exceeds the amount realized on the sale or exchange. I.R.C. § 1001(a). Recognition (deduction) of the loss will depend on whether it is allowed by Code section 165 or another section, and whether it is disallowed, in whole or in part, by any of the many disallowance provisions of the Code. *See*, *e.g.*, I.R.C. §§ 267, 1031(a), (c), 1211.

§ 1001(a). The shareholder will recognize the realized gain in the year of sale.

If the property sold or exchanged is a "capital asset" under Code section 1221, as stock generally is, any gain recognized will be capital gain. *See* I.R.C. § 1222.

> *Example 1.5*: Corpo, Inc. has three shareholders, Darren, Ellen, and Fred. Darren, who has a basis in his shares of $30, sells them for $100. Darren has taxable gain of $70 ($100 $30). The $70 gain is capital in character.

If the taxpayer has a "net capital gain," that will be taxed at preferential capital gains rates under Code section 1(h).

If instead of selling stock, a shareholder were to receive a distribution of corporate profits, the shareholder would also have gross income at that time—that is, in the year of the distribution. However, in this instance, the income would be ordinary, not capital, in nature. In addition, the *full amount* of a dividend is taxed as ordinary income.[16]

> *Example 1.6*: Corpo, Inc. makes a distribution to its remaining shareholders that is taxable as a dividend. Ellen, one of the shareholders, receives a dividend of $100. The $100 constitutes ordinary income to Ellen.

Thus, for both the advantage of "basis offset" and the possible preferential treatment of capital gains, non-corporate taxpayers generally prefer sales treatment to distribution treatment.[17]

The different tax treatment of the sale of stock in Example 1.5 and the distribution with respect to the stock in Example 1.6 does reflect an economic difference in the two scenarios. By selling the stock, a shareholder is actually divesting. In addition, a sale to a third party does not occasion a distribution of corporate profits. A distribution, by contrast, bails out profits without diminishing the shareholder's ownership interest in the corporation. However, as discussed in Chapter 5, certain corporate transactions, such as corporate redemptions (buy-backs) of stock, resemble both sales and distributions. The distinction between ordinary income and capital gains treatment (with basis offset) drives characterization issues with respect to those transactions.

§ 1.04 Introduction to the Backstops to the Corporate Tax System: The Substance-Over-Form and Step-Transaction Doctrines

"Rules are made to be broken," and creative taxpayers and their talented advisors have developed transactions that apparently meet the letter of the law for favorable tax treatment while arguably failing to comply with the

[16] Chapter 4 considers in detail what portion of a distribution actually constitutes a dividend under section 301. *See* § 4.03[B].

[17] As discussed in Chapter 4, corporations benefit from a dividends received deduction that effectively results in an exclusion from taxable income of all or part of each dividend received. *See* § 4.04.

spirit or substance of the provision. As a result, courts have developed two important doctrines that attempt to ferret out abusive transactions that do not qualify for the beneficial tax treatment sought. These doctrines are called "substance-over-form" and the "step-transaction doctrine."

[A] The Concept of Substance-Over-Form

This doctrine generally provides that the substance of a transaction will triumph over its form. Thus, a transaction that complies with the letter of a statute but in substance violates it will generally not be taxed under that statute. It is generally the IRS that raises this doctrine, seeking to recharacterize the transaction engineered by the taxpayer. Courts are much less sympathetic to taxpayers seeking to ignore the form of the transaction because, after all, it is the taxpayer that chose the form. Because substance-over-form is generally a one-way sword, taxpayers are well-advised to plan carefully, choosing the optimal form (consistent with the substance) up front, rather than attempting later to disavow the chosen form.

[B] The Step-Transaction Doctrine

[1] In General

Sometimes taxpayers will seek to divide a transaction into multiple smaller transactions or to combine several smaller steps into one transaction. Because many corporate transactions involve multiple steps, determining where a transaction begins and ends may in turn determine the proper tax treatment. The step-transaction doctrine consists of three judicially developed tests to determine whether apparently or purportedly separate steps are in fact part of an integrated whole that forms "the transaction."

[2] The Three Tests for a "Step Transaction"

[a] Binding Commitment Test

A binding contract or commitment to engage in step two (or three) in existence at the time of step one almost certainly will result in a collapsing of the steps into a single transaction.[18]

Example 1.7: Glenda, Harry, and Isaac plan to incorporate a corporation. They enter into a contract with Janet to transfer 25 percent of the corporation's shares to her, once Janet does all of the necessary

[18] Examples 1.7 through 1.9 relate to organization of a corporation, a topic that is a focus of Chapter 2. That chapter discusses in detail the requirements of section 351, which allows nonrecognition to transferors of property who control a corporation. In the context of section 351, it matters who is considered part of the "transferor group." *See* § 2.02[A][1][c]. However, it is not necessary to understand section 351 to see how the step-transaction doctrine operates to characterize multiple steps as a single transaction.

paperwork to organize the corporation and issue shares. Janet will almost certainly be considered a member of the group organizing the corporation.

[b] Mutual-Interdependence Test

Absent an *ex ante* binding commitment to engage in step two or subsequent steps, those steps may still be amalgamated with step one to constitute a single transaction, if step one and the subsequent step (or steps) are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.

Example 1.8: Kara, Lionel, and Mary plan to incorporate a corporation but do not know how to do so. They ask Nancy to do all of the necessary paperwork to organize the corporation and issue shares. Nancy does so, and, as planned, the three shareholders of the corporation cause 25 percent of the corporation's shares to be issued to Nancy. Nancy will likely be considered a member of the group organizing the corporation, even without a binding contract to receive the shares, because issuance of the shares to her was an integral part of the incorporation transaction.

[c] End-Result Test

The third test sometimes used under the step-transaction doctrine is called the end-result test. It is similar to the mutual-interdependence test. It provides that separate steps may be combined if they were prearranged components of a single transaction in which the parties intended from the outset to reach a particular result.

Example 1.9: Oswald, Penelope, and Quincy plan to incorporate a corporation but they would prefer to be minority shareholders in a corporation controlled by someone else. They plan to bring in an appropriate fourth person after the corporation is incorporated. The corporation is organized in December. In February, Rhonda contributes services and property, and receives 51 percent of the shares. Rhonda may be considered a member of the group organizing the corporation, even though she had not been identified prior to the incorporation, because transfer of a majority of shares to a fourth person was the end result intended from the beginning of the transaction.

§ 1.05 Conclusion

This chapter has explained how Subchapter C corporations and their shareholders are double-taxed, methods used to minimize or eliminate one layer of taxation, and the prospect for the future for legislative relief from double taxation. It has also explained the importance to corporate taxation of the somewhat arbitrary distinction between capital gains and ordinary income. That distinction will resurface throughout the book. The final topic of the chapter, the judicial backstops to the corporate tax system, will reappear just as often throughout the book. As you will see, compliance with the formalities required by the Code is but the first step in obtaining the desired tax consequences. Having a "substantive" business purpose for the form of the transaction may well be a necessary second condition.