Acc. 433, Chapter Outline for use with Prentice Hall's Federal Taxation Corporations

1) Chapter 1 was not assigned!
2) Formation and Capital Structure
   a) Taxable year
      i) Can pick a fiscal year (must be a month end)
      ii) Personal Service Corporations must generally use a calendar year
   b) Different entities can exist, but they can be taxed as corporations!
   c) Corporations can elect not to be taxed (S Corporation)
   d) Taxable corporations are called C Corporations
      i) Advantages
         (1) Corporation pays the tax at 15% on first $50,000
         (2) Shareholders are employees - thus medical expense deduction and no income to the "employee"
         (3) Protection from creditors (can use LLC)
      ii) Disadvantage
         (1) Second tax when corporate profits are eventually paid out
   e) Partnerships (2 or more) such as limited liability companies, can elect to be treated as a corporation (Check the Box)
   f) Must be legally formed
   g) Taxation at formation - Section 351 states that no gain shall be on the transfer of to a controlled corporation for its stock (not debt)
         (1) Gain is realized, but not recognized
         (2) Only defers gain, and only on property, not services
         (3) Transferors must control the stock (80% or greater)
         (4) Gain if liabilities exceed basis (up to the difference)
         (5) Gain up to the amount of boot receive - anything received except for securities (cash, bonds, other property)
         (6) Section 351 is mandatory, if it applies, no loss can be taken!
   h) Shareholder contributions to the corporation - The corporation does not recognize income, gain etc. on contributions to capital by the shareholder
   i) Capital contributions by non-shareholders is not income, unless it is not invested in assets within 12 months. If it is, the basis of the property is reduced by the amount of the contribution
   j) Worthless Stock - Section 1244 allows an ordinary loss to the original shareholders (rather than a capital loss) for up to $50,000/$100,000

3) The Corporate Income Tax
   a) The first year can not exceed 12 months.
   b) Accounting method
      i) Generally the accrual method must be used. It must always be used if inventory is a materially income producing activity
      ii) For service business (no inventory) cash method may be used if
         (1) Family farm
         (2) Personal Service Corporation
         (3) Less $5,000,000 gross receipts in any prior year

c) Taxable income is similar to individuals, except:
   i) Capital Gains are taxable and no favorable tax rate
   ii) Capital losses are not deductible
      (1) They carry back 3 years and forward 5 to offset capital gains in those years. Use them or loose them
      (2) Not elective, must carryback
   iii) Organization, Syndication and start-Up expenses
      (1) Organization (business plans, lawyer's fees for article of incorporation, etc.) and start-up (also pre-opening costs) can not be expensed
      (2) Must elect to amortize over 60 months
      (3) Beginning when business begins
   iv) Syndication cost (sales and promotion cost) are not deducible
   v) Charitable contributions:
      (1) Deducible in the year paid
      (2) Can be accrued, see book
      (3) Limited to 10% of taxable income, before the charitable contribution, NOL carryback and dividends received deduction
   vi) Dividend received deduction:
      (1) 70% for less than 20% ownership
      (2) 80% for 20% but less than 80% ownership
         (a) Calculation is a bit strange.
         (b) It is the lesser of 70% (or 80%) of the dividends received or of taxable income
         (c) Except that the full amount of the 70% (or 80%) of dividends received can be used if it creates or increases a NOL
      (3) 100% if 80% or greater ownership
         (a) Must hold the stock for at least 45 days
         (b) 90 days if preferred stock

d) Net operating loss

        (1) Essentially it is when taxable income is less than 0!
        (2) Losses are carried back 2 years and forward 20
        (3) Can elect not to carry back (must separately elect not to carry back the AMT NOL

e) Closely held provisions
    i) Sales of depreciable property from a >50% shareholder to the corporation will result in ordinary income rather than Section 1231 (capital) gain
    ii) Losses of any kind between the corporation and the related taxpayer are disallowed
    iii) Deductions that are taken by an accrual basis corporation for accruals to a related (cash basis) party are deductible in the year the cash basis shareholder reports the income (when it is paid), such as accrued salary or rent paid to a sole shareholder

f) Income tax liability - see tables, 15% to 35%

g) Personal Service Corporation must pay tax at a flat 35%
    i) Must be personal services of shareholders, and
    ii) Be accounting, health, law, engineering, architecture, actuary, performing arts or consulting

h) Controlled groups
    i) Parent Sub vs.
    ii) Brother-Sister

i) Consolidated Return - Entities (Parent-Sub)
    i) Allows adding all numbers as if it is one return
    ii) Must be elected by all members, then mandatory for new corps.

j) Estimated Taxes
    i) Due April, June, September and December (15th)
    ii) Lower of 100% of current or prior year's return (but only if the prior year had a tax!)
    iii) Special rules for large corporations

k) Due date of the return - 15th day of 3rd month (March 15th for a calendar year corporation!)

l) Tax Return -
    i) Book vs. Taxable income - Sch. M-1
        (1) Temporary or timing differences such as depreciation, bad debts,
        (2) Permanent differences such as life insurance, business meals
    ii) Reconcile retained earnings - Sch. M-2

4) Corporate Non liquidating Distributions
   a) Issue: Is the distribution a dividend, return of capital or capital gain?
   b) Non liquidating distributions are usually a dividend
   c) Dividend is defined as a distribution from either Current, or accumulated Earnings and Profits ("E & P")
   d) Earnings and profits is not defined, but similar to retained earnings
   e) Effect on Corporation of the distribution of property
      i) Gain (on appreciated property distribution) is recognized at the corporate level on property distributions to shareholders as if the property were sold for FMV
      ii) Loss is not recognized (should sell the asset and distribute the cash)
   f) Effect on Shareholder
      i) Amount of the distribution is FMV (Gross FMV - liabilities)
      ii) Basis of the property is gross FMV
   g) Effect on the Corporation's Earnings and Profits
      i) Net effect is to reduce E & P by the Adjusted Basis of the distributed property (and the federal income tax paid) because:
      ii) Gain increases E & P, and
      iii) Distributions reduces E & P by FMV
   h) Constructive Dividends are items that are not on the books as dividends, but which the IRS determines are, in effect dividends, such as:
      i) Excess compensation to shareholders
      ii) Loans to shareholders that are not paid back (not really loans)
      iii) Corporate payment of shareholder's expenses
   i) Stock Dividends are not taxable if all shareholders receive the same percentage of shares, thus the effect is to keep all shareholders ownership the same before and after
      i) For example, 1 share for each share owned
      ii) Taxable if any shareholder can get cash, property, or in any way have the effect of changing the percentage ownership between the shareholders
   j) Stock Redemptions - A repurchase of shares by the corporation - will be a dividend, unless it falls within one of the following tests:
      i) Substantially disproportionate - After must own (including attribution)
         (1) Less than 50% of the stock
         (2) Less than 80% of the prior ownership %
      ii) Complete termination of the shareholders interest (including attribution) - Can waive attribution on complete termination if
         (1) Does not retain any interest (including as an employee) except as a creditor (to get paid)
         (2) Must remain a non owner for 10 years
         (3) Must agree to inform IRS if he or she does reacquire an interest
   k) Not essentially equivalent to a dividend - Very hard to prove given test (1) above
   l) Partial Liquidation - when the company sells of an independent division and distributes the proceeds
   m) Redemption to pay death taxes -
      i) Qualifies only if the value of the stock > 35% of the adjusted gross estate
      ii) Amount of the redemption that qualifies for capital gain treatment is equal to federal estate tax, state inheritance tax, funeral and administrative expense
      iii) The above limits the amount, there is no requirement that the estate need the cash
         (1) Because basis at death = FMV, there will be little if any gain as long as the "redemption" qualifies - if not, the distribution will be a dividend

iv) Attribution generally applies - Thus, a shareholder is considered to own both his/her/its own shares plus those owned by
   (1) Spouse, children, grandchildren and parents
   (2) Prorate from a partnership
   (3) From a corporation if shareholder owns (directly or indirectly 50% or more of the stock

5) Other Corporate Tax Levies
   a) Alternative Minimum Tax
      i) Involves calculating: (AMT Income - exemption) X 20% tax rate
      ii) Exemption:
         (1) $40,000
         (2) Phased out by 25% of AMTI over $150,000
         (3) Exception for small businesses, those with average gross income less than 7,500,000 for the prior three years
      iii) Tentative AMT Tax - Regular Tax = AMT Tax
         (1) AMT Income = Regular income,
      iv) Plus, preferences like AMT tax exempt bond interest
      v) Plus or minus,
         (1) Depreciation
         (2) Gains on sales
         (3) 75% of ACE - AMTI
            (a) ACE is essentially book income, - thus items like tax exempt interest and life insurance may become taxable!
            (b) AMT income prior to ACE
            (c) The effect is to pay tax on 75% of Book income at a 20% tax rate!
         (4) AMT NOL (separate AMT calculation) is limited to 90% of AMTI (Effective tax rate is therefore 2% for all large income companies! 10% x 20%)
   b) Personal Holding Company (incorporated pocket books!)
      i) Subject to penalty tax of 15% (the same tax as that on dividends)
      ii) Definition -
         (1) 5 or fewer shareholders own more than 50% of the stock, and
         (2) personal holding company income is at least 60% of adjusted ordinary gross income for the year
         (3) Attribution here is different than liquidation, includes brothers and sisters, spouse ancestors and lineal descendants
      iii) PHC Income
         (1) Dividends (no dividends received deduction allowed)
         (2) Interest
         (3) Annuities
         (4) Rent (as adjusted)
      iv) Not treated as PHC income if at least 50% of income and dividend of other PHC income over 10% is paid
      v) Thus, can be in the rental business and not be a PHC
         (1) Royalties
         (2) Produced Film Rentals
      vi) Personal Service Contracts will be PHC if

(1) Someone other than Corporation has the right to name the employee who is to perform the services
(2) 25% or more of the stock is owned by that person who can be designated
(3) Applies to "Loan Out" corporations (incorporated actors and actresses)

vii) Tentative tax (PHC Income) can be reduced by paying a dividend
(1) Note, no dividends received deduction
(2) Actual payment
(3) Election to treat dividends within 2 1/2 months as retroactive
(4) Consent dividend - agreeing to report the PHC income as dividends, even though not paid
(5) Deficiency Dividend - agreeing to pay a dividend when the IRS catches you - taxable in the year "paid" - but interest and penalty still apply, just not the corporate tax
(6) NOL for PCH income purposes only qualifies for a one year carry forward! Thus, can have no regular tax liability, but a PHC tax the subsequent years

c) Accumulate Earnings Tax (penalty for not paying a dividend)

i) Technically applies to all corporations (but generally does not apply to publicly traded companies)

ii) Applies on an annual basis
(1) Applies if the corporation is formed or availed of to keep the profits at the corporate level rather than distributing the excess amounts (over the needed amounts) to the shareholders, where a second tax would apply)
(2) What are unreasonable accumulations?
(a) Loans to shareholders
(b) Investments in stocks, bonds etc. having no relationship to the business
(3) What are reasonable accumulations of profits?
(a) Future needs (like a down payment for a building
(b) Redemptions for death taxes (but only after the shareholder has died!)
(c) Product liability losses
(d) Inventory and business needs (Bardahl formula)
(4) Other business contingencies and expansion or acquisition needs
(5) Important for the Board of Directors to consider this problem
(6) Determining the Tax (Accumulated Earnings Income x 15%)
(a) Current taxable income + dividends received deduction
(b) Less all charitable deductions - no limit
(c) Less capital losses
(d) (effectively taxable cash flow?)
(e) Minus dividends paid (as in the PHC)
(f) Minus - accumulated earnings credit

        iii) $250,000 since inception, $150,000 for personal service corporation, or
        iv) Amounts actually needed for the business, if higher

6) Corporate Liquidating Distributions
    a) Discontinuation of the corporation and liquidation - must cancel or redeem all the shares
        i) Winds up affairs
        ii) Pays all of its debts
        iii) Distributes remaining assets to its shareholders
    b) Shareholder tax treatment
        i) Treated as a sale or exchange (capital gain or loss) equal to the FMV - Adjusted Basis of the stock
        ii) §1244 may create ordinary loss
        iii) If shareholder later has to pay corporation's debts, a capital loss is permitted, not an ordinary expense (deduction)
        iv) No gain or loss and carryover basis, if liquidation is to a controlled parent (80% or greater owner) - since a dividend to such parent would also be tax free!
            (1) Distribution must be in one tax year, or
            (2) Series of transactions within 3 years of beginning
            (3) All tax attributes carryover
    c) Corporation's tax treatment
        i) Any gain or loss must be recognized by the corporation on distribution of property
        ii) No loss if distribution is to greater than 50% shareholder
        iii) No gain or loss if distribution to controlled parent (80%)
        iv) Expenses of the liquidation are deductible
            (1) If they create an NOL, it can be carried back only two years
            (2) Remember to write off things like goodwill, syndication costs
        v) Must file Form 966 within 30 days of adoption of the plan of liquidation - not done on a timely basis all the time!

7) Corporate Acquisitions and Reorganizations
    a) Can purchase the target corporation's assets
        i) Then the assets are treated as new assets
        ii) Seller pays tax on the gain (loss)
        iii) Liabilities stay those of the seller, unless part of the transaction
    b) Can purchase stock
        i) Generally doesn't affect the tax basis of the underlying assets
        ii) Purchaser gets assets and liabilities (unknown ones!)
        iii) If liquidates the controlled subsidiary - carry over basis (last chapter) - If purchase price is greater than tax basis of assets, the difference disappears
        iv) Seller's generally get capital gain or loss on sale of stock
        v) May elect §338 deemed purchase of assets and deemed liquidation
            (1) Must be elected
            (2) Gain is reported by "selling" corporation
            (3) Must acquire 80% ownership
            (4) Basis in "new" company are each assets purchase price, plus liabilities

c) Allocation of basis in the case of a purchase must be by category (Residual Method):
   i) Class I, cash, bank accounts, etc.
   ii) Class II, CD's US Govt securities, marketable securities
   iii) Class III, all other property, and then
   iv) Class IV, Intangible assets in the nature of Goodwill, which are now amortizable, straight line, over 15 years, such as Goodwill, going concern, turn-key value, customer lists, etc.
   v) Class IV is really what falls out after class I - III have been allocated based on their respective FMVs
d) Tax Free Reorganizations ("purchases" that are not treated as taxable transactions) under §368(a) - (g) - If qualified then no gain or loss to anyone, except as listed below! Only applies to stock. Securities are tax free (bonds) only if used in the same face amount. In most cases the end result is a parent (acquire) and subsidiary (target). Thus, it is the form that controls, not the end result!
   i) - A - Statutory Merger or Acquisition (Two companies into one under state law
      (1) The two companies become one
      (2) Great flexibility - simply must acquire 50% for stock
      (3) Any cash used is taxable boot
      (4) Can do a triangular merger
         (a) Set up a new subsidiary with stock of the parent
         (b) Do an A reorganization (merger) into the shell company for stock of the parent
   ii) - B - Stock for Stock
      (1) Solely for voting stock
      (2) Cash can be used only for fractional shares
      (3) Must acquire control, 80% of each class of stock
      (4) As in all reorganizations, the relative sizes of the two companies is not important
   iii) - C - Asset for Stock (avoids most shareholder problems)
      (1) Solely for voting stock of the acquiring corporation
      (2) Must acquire at least 80% of the assets for stock
      (3) Must get substantially all of the assets
         (a) 70% of FMV of gross assets
         (b) 90% FMV of net assets
      (4) "Acquired" corporation must distribute all of the stock
      (5) Acquired corporation must liquidate or dissolve
      (6) Can do triangular
   iv) - D - We will be doing only the divisive D - splitting up of one company into two
      (1) Split off, spin off, split ups, etc.
      (2) Shareholder allocates basis to the new shares
      (3) Can be pro-rata or any combination of after reorganization ownership
         (a) A could simply spin off B to all shareholder
         (b) Jim could keep A and Mary could get all of B
         (c) Any other combination is allowed
      (4) §355 requirements
         (a) Solely stock or securities
         (b) Not a method of creating a disguised dividend
         (c) Both companies must be active businesses after the split
         (d) Each must have been active business for the past 5 years (can split one five year old business down the middle)
         (e) Must be a business purpose

v) - E - Recapitalization
   (1) Common stock for common stock
   (2) Common or preferred for preferred stock
   (3) Stock for debt (except that stock for accrued interest is taxable)
   (4) Bonds for new Bonds - but tax free only on like amounts of principal
   (5) Additional principal is taxable
   (6) Can increase interest rate!
vi) - F - Change of
   (1) Name
   (2) Form
   (3) Place of Incorporation
vii) - G - Bankruptcy reorganization – not covered in class

e) Judicial requirements applies to all reorganizations
   (1) Continuity of Proprietary Interest (that the shareholders continue as owners - IRS is getting more lenient on this, except in an A reorganization
   (2) Continuity of Business Enterprise - the company stays in the historic business or the new company uses the acquired company's assets
   (3) Business purpose - there must be a business reason for the transaction

f) Tax Attributes generally carry over, except

g) §382 Change of Ownership provides that carryovers (losses, credits, etc.) are limited if
   i) There is a shift in greater than 5% owners (except in a D) of over 50% during the testing period
   ii) Testing period is three years (rolling, not calendar years!)
   iii) If there is such a change, by additional shareholders or contraction, then, the loss carry over is limited to:
      (1) FMV of the stock at the time of the change, times
      (2) Then long-term tax exempt interest rate
      (3) This amount can be used each year or until the NOL is used up
      (4) Once freed up it can be used in a future year
         (a) Even this amount eliminated if the historic business is not continued for at least two years

8) Chapter 8 - Consolidated returns.
   a) Must own 80% of the subsidiary
   b) Must elect (by each corporation) to be part of the initial consolidated return.
   c) Once elected, any new members are part of the group. They need not elect and can't elect out.
   d) Advantage of a consolidated return is that all calculations are made as a group. Thus, one corporation's income can offset another's loss. Same with capital gains and losses, charitable contributions limitations, etc.
   e) Inter-company sales are eliminated until the product is eventually sold by the group.
   f) Dividends received deduction is 100%