Corporate Tax Outline

[Business Taxation Overview 1](#_Toc418081224)

[Tax Imposed - § 11 1](#_Toc418081225)

[Deductions for “Reasonable” Salaries - § 162(a)(1) 1](#_Toc418081226)

[Corporation Defined - § 7701(a)(3) 1](#_Toc418081227)

[Publicly Traded Partnerships - § 7704 2](#_Toc418081228)

[Social Security and Medicare Taxes 2](#_Toc418081229)

[Corporations vs. Trusts 3](#_Toc418081230)

[Separate Corporations with Same Owners - § 1561 3](#_Toc418081231)

[Subsidiary Dividend to Parent Corporation - § 243 3](#_Toc418081232)

[Consolidated Filing § 1501 4](#_Toc418081233)

[Corporate Agent (Commissioner v. Bollinger) 4](#_Toc418081234)

[Alternative Minimum Tax § 56 4](#_Toc418081235)

[Net Investment Income Tax and Pass-through Income 4](#_Toc418081236)

[Formation of a Corporation 5](#_Toc418081237)

[Section 351 Exchanges 5](#_Toc418081238)

[Corporation’s Tax Effect (§ 1032) and Basis (§ 362) 5](#_Toc418081239)

[Depreciation Recapture (§ 1245) 5](#_Toc418081240)

[Installment Notes and § 453B 5](#_Toc418081241)

[Effect of a Good § 351 Exchange 6](#_Toc418081242)

[Requirements of a Good § 351 6](#_Toc418081243)

[“Boot” in a § 351 7](#_Toc418081244)

[Assumption of Liabilities § 357 8](#_Toc418081245)

[Incorporation of a Going Business 9](#_Toc418081246)

[Contributions to Capital § 118 9](#_Toc418081247)

[Avoiding § 351 9](#_Toc418081248)

[Organizational and Start-Up Expenses 10](#_Toc418081249)

[Capital Structure 11](#_Toc418081250)

[Debt vs. Equity § 385 11](#_Toc418081251)

[Character of Gain or Loss on Corporate Investment 11](#_Toc418081252)

[Nonliquidating Distributions 12](#_Toc418081253)

[Distributions in General § 301 12](#_Toc418081254)

[Dividends and Earnings and Profit § 316 13](#_Toc418081255)

[Distributions of Non-Cash Property 14](#_Toc418081256)

[Constructive Distributions 14](#_Toc418081257)

[Redemptions and Partial Liquidations 15](#_Toc418081258)

[Redemptions Generally §302 15](#_Toc418081259)

[Complete Termination § 302(b)(3) 15](#_Toc418081260)

[Constructive Ownership of Stock § 302(c) 15](#_Toc418081261)

[Substantially disproportionate Redemptions § 302(b)(2) 17](#_Toc418081262)

[Redemptions Not Essentially Equivalent to a Dividend § 302(b)(1) 17](#_Toc418081263)

[Partial Liquidations § 302(b)(4) 18](#_Toc418081264)

[Consequences to the Distributing Corporation 18](#_Toc418081265)

[Redemptions through Related Corporations § 304 19](#_Toc418081266)

[Redemptions to Pay Death Taxes §303 19](#_Toc418081267)

[Stock Dividends and Section 306 Stock 19](#_Toc418081268)

[Stock Dividends and Splits 19](#_Toc418081269)

[Taxation of Stock Distributions § 305 20](#_Toc418081270)

[§ 306 Stock 21](#_Toc418081271)

[Complete Liquidations 21](#_Toc418081272)

[Complete Liquidations under § 331 21](#_Toc418081273)

[Liquidation of a Subsidiary § 332 (Parent) and § 337 (Subsidiary) 22](#_Toc418081274)

[Taxable Corporate Acquisitions 23](#_Toc418081275)

[Stock Acquisition 23](#_Toc418081276)

[Asset Acquisition 23](#_Toc418081277)

[Reorganizations 24](#_Toc418081278)

[Reorganizations (Ch 9-12) 24](#_Toc418081279)

[§ 361 - Corporations in a Reorganization 24](#_Toc418081280)

[§ 354 - Shareholders in a Reorganization 25](#_Toc418081281)

[In order to be a Reorganization: 25](#_Toc418081282)

[§ 368(a)(2)(E) Triangular Mergers 26](#_Toc418081283)

[Anti-Avoidance Rules 26](#_Toc418081284)

[Economic Substance Doctrine 26](#_Toc418081285)

[Accumulated Earnings Tax (§ 531) 26](#_Toc418081286)

[Personal Holding Company Tax 26](#_Toc418081287)

[S Corporations 27](#_Toc418081288)

[Generally 27](#_Toc418081289)

[S Corporation Not Taxed § 1363 27](#_Toc418081290)

[Shareholder of S Corporation Pass-Thru Tax § 1366 27](#_Toc418081291)

[Eligibility Requirements § 1361 28](#_Toc418081292)

["Small Business Corporation" under IRC § 1361(b) 28](#_Toc418081293)

[Election: IRC § 1362 29](#_Toc418081294)

[Terminating S Status 29](#_Toc418081295)

[S Corporation Operations 29](#_Toc418081296)

[Example 30](#_Toc418081297)

[S-Corporation Operations 30](#_Toc418081298)

[C-Corps To S-Corps 30](#_Toc418081299)

[Example 30](#_Toc418081300)

[Former c-corps. - Appreciated Property 31](#_Toc418081301)

[Former C-Corps. - Dividends 31](#_Toc418081302)

[Former C-Corps with E&P And Passive Investment Income 31](#_Toc418081303)

# Business Taxation Overview

## Tax Imposed - § 11

* 15% on first $50,000
* 25% on next $25,000
* 34% on income from $75,000 to $10,000,000
* 35% on income over $10,000,000
* For corporations with substantial amounts of income, the tax benefits of the lower brackets are phased out – over 18,333,333 flat 35% on all income
  + For corporations earning over 100k, the amount of tax is increased by the lesser of 5% of such excess or $11,750.
  + If the corporation has more than $15M, the amount of tax is increased by an additional amount equal to the less of 3% of such excess or $100k.
* **Personal Service Corporation Exception §11(b)(2)**: Personal Service corporations do not get the lower brackets. Instead, they are taxed at 35 percent.
  + **Defined § 448(d)(2)**: Two Requirements:
    - 1) Substantially all of the activities of the corporation involve the performance of services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and
    - 2) substantially all of the stock (by value) is held directly (or indirectly through companies/partnerships) by employees, retired employees, estates of employees, or any other person who had acquired the stock from such an employee.
  + They can, however, use the cash-method of accounting under § 448.

## Deductions for “Reasonable” Salaries - § 162(a)(1)

* A “reasonable” allowance for salaries and other compensation for personal services
* This is to prevent the corporation from paying dividends as salaries to escape paying corporate tax.

## Corporation Defined - § 7701(a)(3)

* “corporation” includes associations, joint-stock companies, and insurance companies.
* Reg. § 301.7701-1: discusses whether a separate entity exists at all.
  + Certain joint undertakings give rise to entities for federal tax purposes.
  + A joint venture or contractual arrangement may create a separate entity if the participants:
    - Carry on a trade, business, financial operation, or venture and divide the profits.
    - Exception: This does not include a joint undertaking merely to share expenses.
    - Exception: This also does not include mere co-ownership of property that is maintained and rented or leased.
* Reg. § 301.7701-2: Defines what IS a corporation.
  + A business entity is any entity recognized for federal tax purposes that is not a trust.
  + A business entity with two or more members is either a corporation or a partnership
  + A business entity with only one owner is classified as a corporation or disregarded.
  + A business entity is a corporation if a federal or state statute describes it as a corporation. So, if you’re a corporation under state law, you are a corporation for IRC.
  + An association – as defined under 301-7701-3.
  + A joint-stock company or association.
  + Insurance company.
  + State chartered business entity conducting banking activities
  + Certain foreign entities.
* Reg. § 301-7701-3 (“Check the Box Regulation”)
  + (a) A business not already classified as a corporation can elect to be classified as an association (and thus corporation).
  + (b) If you don’t make this election, then (b) defines your tax status. These are the default rules.
    - If you have two or more members, you’re a partnership.
    - Otherwise, you’re a disregarded entity.
  + (c)(1)(iv) Limitation: Once you make an election, you cannot elect to change its classification in the next 5 years.
  + (g) Changing Tax Treatment:
    - (1)(i) Partnership to Association: If an election is made, the following occurs: the partnership contributes all of its assets and liabilities to the association in exchange for the stock in the association and then the partnership liquidates by distributing the stock of the association to its partners.
    - (1)(ii) Association to Partnership: If an election is made, the following occurs: the association distributes all of its assets and liabilities to its shareholders in liquidation of the association and immediately thereafter, the shareholders contribute all of those assets and liabilities to a newly formed partnership.
    - This isn’t a big deal going from partnership to association, but the tax implications for liquidating a corporation can be huge when going from association to partnership.

## Publicly Traded Partnerships - § 7704

* (a) Generally, publicly traded partnerships are treated as a corporation.
* (c) provides a narrow exception for if 90% or more of the company’s gross income comes from qualified income as defined by (d).

## Social Security and Medicare Taxes

* Employer/Employee Situation:
  + 6.2% Social Security tax for employer and employee
  + 1.45% Medicare tax for employer and employee
  + No Personal Exemption
  + Social Security Wage Base for 2015: $118,500 – this is the capped social security wage tax amount
* Self Employment
  + 12.5% social security tax
  + 2.9% medicare tax
  + Tax base: 92.35% of net earnings from self-employment
  + Filing threshold: $400 of net earnings from self-employment
  + Social security base for 2015: $118,500 minus wages
* Medicare Surtax: After $200k ($250k for married, joint return) of wages, compensation, or self-employment income, taxpayer pays an additional 0.9% in Medicare surtax.
* Medicare Taxes on Net Investment Income
  + 3.8% of net investment income
  + Applicable only to extent adjusted gross income is greater than $200,000 ($250,000 married)
  + Applicable to investment income (dividends, interest, recognized gains on stocks, bonds) income from financial trading business, and passive activity income
  + Not applicable to income from non-rental, non-financial-trading business activities in which taxpayer materially participates
  + Not imposed on wages or self employment income
  + This is § 1411.
* Choice of Entity Consideration:
  + Partnerships and Wages: Wage tax is not applicable to partners in a partnership
  + Partnerships and Self-Employment Tax: Self-employment tax is imposed on pass through income from partnership business to general partners (NOT imposed to limited parters)
  + S-Corporations Pass-Through Income: Self-employment tax is NOT imposed on pass-through income from S corporations to shareholders
  + S-Corporations Wages: Wage tax is imposed on S corporation shareholders only to the extent of wages paid.
    - If you don’t take out wages, you never have to pay SS/Medicare taxes – however, the IRS will look at blatantly evasive actions – you’re supposed to take out a ‘reasonable’ wage.

## Corporations vs. Trusts

* Trusts are not pass-through entities, but they are single-tax. When a trust earns income, that is taxed to the trust if the trust accumulates it. If it distributes to the beneficiaries, just the beneficiaries pay the tax.
* Reg. § 301.7701-4:
  + (a) Ordinary Trusts:
  + (b) Business Trusts: Generally created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations. These are classified as corporations or partnerships under the IRC. So, if the trustee is actively carrying on a business, it cannot be a trust.
    - This often arises in property rental. If the trustee is simply receiving a check, you’re likely a trust, but if there’s a bunch of property management, that would be a business trust.

## Separate Corporations with Same Owners - § 1561

* IRC § 1561(a)(1): If you have a controlled group of corporation, their tax liability is combined. It will essentially treat this group of corporations as one.
* § 1561(a)(2) Brother-Sister Controlled Group: Two or more corporations will aggregate their income if 5 or fewer persons possess more than 50% of the total combine voting power or more than 50% of the total value of shares of each corporation.
* § 1561(e) Constructive Ownership: Shares held by family members are considered held by you for determining this aggregate value.

## Subsidiary Dividend to Parent Corporation - § 243

* The parent corporation must pay tax on this dividend, but it gets a deduction equal to most of or the entire dividend.
  + § 243(a)(2): 100 percent deduction in the case of dividends received by a small business investment company.
  + § 243(a)(3): 100 percent in the case of qualifying dividends defined in (b)(1)
  + § 243(a)(1): 70 percent deduction in all other cases.
* § 243(b)(1) Qualifying Dividends: Any dividend received by a corporation if such corporation is a member of the same affiliated group. (b)(2) says that “affiliated group” is defined by § 1504(a).
* § 1504(a) Affiliated Group: An affiliated group means 1 or more chains of includible corporations. The ownership of stock of any corporation meets the requirement if (A) it possesses at least 80 percent of the total voting power of the stock and (B) has a value of at least 80 percent of the total value of the stock.
  + So, essentially, the parent company must own 80% of the voting power and total value of the stock to get the 100% deduction. Otherwise, you’re stuck with the 70% deduction.
  + 70% to 80% Bump: Further § 243(c) indicates that if you own at least 20% of the value and voting power of the subsidiary, the 70% deduction can be bumped to 80%.

## Consolidated Filing § 1501

* An “Affiliated Group” can file a consolidated tax return for the whole group in lieu of separate returns.
  + Cannot contain foreign companies.
  + Further, any transactions within the group are ignored.

## Corporate Agent (Commissioner v. Bollinger)

* Agency relationship is established if:
  + Written agency agreement
  + Corporation functions as agent and never as principal
  + Corporation is held out as agent in all dealings with third parties
* This is all you need to ignore the c-corporation.
* And, you CAN have a related party be your agent - you don't need the arm's length relationship.
* National Carbide Factors:
  + Corporation operates in the name and for the account of the principal
  + Corporation binds the principal
  + Transmits money to the principal
  + Income attributable to services of the employees of the principal
  + Relations with the principal must not be dependent upon the fact that it is owned by the principal; AND business purpose must be the carrying on of the normal duties of an agent.

## Alternative Minimum Tax § 56

## Net Investment Income Tax and Pass-through Income

* Net investment income tax is not imposed on tax-free distributions from s-corporations to shareholders, or from partnerships to partners
* Net investment income tax is imposed on investment income passing through from s-corporations to shareholders, and from partnerships to partners

# Formation of a Corporation

## Section 351 Exchanges

* **General Rule**: No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange, such persons are in control of the corporation.
  + In this case, property includes money.
  + **Control** here is defined in **§ 368(c):** ownership of stock possessing at least 80 percent of the total combined voting power and at least 80 percent of the total number of shares.
* **Shareholder’s Basis (§358)**: The shareholder’s basis in the shares received is generally equal to the property exchanged for the shares. (§ 358)
  + The Basis is **decreased** by:
    - FMV of any other property (EXCEPT MONEY) received by the taxpayer
    - The amount of any money received by the taxpayer, and
    - The amount of loss to the taxpayer which was recognized on such exchange
  + The Basis is **increased** by:
    - The amount which was treated as a dividend, and
    - The amount of gain to the taxpayer which was recognized on such exchange.

## Corporation’s Tax Effect (§ 1032) and Basis (§ 362)

* **General Rule §1032**: The corporation never has income when it issues stock in exchange for property (including money).
* **Corporation’s Basis (§362)**: The corporation gets a carry-over basis from the shareholder.
  + **Basis Haircut**: If the property exchanged has a lower FMV than basis, the property gets a basis haircut in the property down to the FMV of the property at the time of the exchange. (§ 362(e)(2)).
    - **Aggregate Transfer**: This applies in aggregate to all of the transferred property. So, you add up the aggregate FMV and the aggregate bases of the property exchanged.
    - **Shareholder Haircut Election**: 362(e)(2)(C) allows the haircut to be taken on the shareholder’s basis in the shares received rather than the corporation’s basis in the property received.
      * This election is not good for S-Corps. Don’t do this election if the company is to become an S-Corp.
* **Tacking the Holding Period (§ 1223)**: Also, the holding period tacks with the property whenever the basis goes with the property.

## Depreciation Recapture (§ 1245)

* Generally, any gain attributable to depreciation should be ordinary income rather than a capital gain. 1245(a)(1) says that if section 1245 property is disposed of, you only get to use the cost-basis rather than the basis adjusted for depreciation, when calculating how much capital gains you have. The rest is ordinary income. Essentially, this forces the depreciation you took to be ordinary income.
* **1245 Property**: This is typically anything you use in your business other than real property.
* **Application to § 351 Exchange**: This doesn’t apply to a good § 351 exchange according to § 1245(b)(3).

## Installment Notes and § 453B

* Ordinary, when you exchange an installment note, you realize all of the gain.
* **Gain/Loss Calculation**: Difference between the basis and
  + 1) the amount realized in the case of satisfaction at other than face value or a sale or exchange; OR
  + 2) The FMV of the obligation at the time of exchange.
* **Application to §351 Exchange**: Reg. § 1.453-9(c)(2) which makes an exception when the exchange is a § 351 exchange.
* **Death of Installment Holder**: §453B(c) treats this gain as income in respect of decedent.

## Effect of a Good § 351 Exchange

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| § 351 Exch. | A | B | C | D | E |
| Partner Gives | $25,000 cash | Inventory worth $10,000 ($5,000 basis) | Unimproved land worth $20,000 ($25,000 basis) | Equipment worth $25,000 ($5,000 basis due to 20k depreciation taken) | Installment note worth $20,000 ($2,000 basis sold last year) |
| Partner Received | 25 shares | 10 shares | 20 shares | 25 shares | 20 shares |
| Tax Consequences? | Not a taxable event. Nothing even realized. | No gain/loss recognized (§ 351) | No gain/loss recognized (§ 351) | No gain/loss recognized (§ 351) | No gain/loss recognized (§ 351) |
| Basis in Stock Received? | $25,000 (Cost basis §1012) | $5,000 (carry-over basis § 358) | $25,000 (carry-over basis § 358) | $5,000 (§ 358) | $2,000 (§ 358) |
| Holding Period for Stock Received? | Not a capital gains item (§1221) | Holding period does not tack because this is not a capital gains item (§ 1221) | Previous holding period (§ 1223(1)) | Previous holding period is tacked (§ 1223) | Probably could tack the holding period (§ 1223) |
| For the Corporation itself? | § 1032 - corporation never has income when it issues stock in exchange for property(including money). | | | | |
| Corporation Basis? | $25,000 (§ 362) | $5,000 (§ 362) | § 362(e)(2) - Basis Haircut Applies!  $20,000 basis | $5,000 (§362) | $2,000 (§362) |
| Notes | Buying with cash isn’t a taxable event. | $5,000 gain is realized under §1001, but § 351 prevents this gain from being recognized | No gain OR LOSS is recognized. § 351 is a two-way street. | § 1245 doesn't apply because of 1245(b)(3). | § 453B doesn't apply because of Reg. § 1.453-9(c)(2) |

## Requirements of a Good § 351

* **Control (351(a))**: Immediately after the exchange the transferors of property participating in the exchange are in control of the corporation.
  + **Control Defined (§ 368(c))**: Control requires:
    - Ownership of 80% voting power; AND
    - Ownership of 80% of the number of shares of the corporation.
  + **“Immediately after the exchange” (Reg. § 1.351-1(a))**: Immediately after the exchange simply means can be right after the exchange or after the end of an integrated plan.
    - **“**The phrase “immediately after the exchange” does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.”
  + **Exception - Services in Exchange for Shares (§ 351(d))**: Services, indebtedness not evidenced by a security, or interest on indebtedness accrued after the shareholder’s holding period are NOT considered as issued in return for property. HOWEVER, they are considered as part of the ownership of stock.
  + **Exception - De Minimus Exception (Reg. § 1.351-1(a)(1)(ii))**: You can’t simply put in some nominal amount of property to make them a transferor of property. An IRS ruling says that if the value of the stock the shareholder gets for property is more than 10% of the value of the shares he’s receiving, then this will be considered a transfer of shares in exchange for property.
* **Investment Company Exclusion (§ 351(e)(1))**: This doesn't apply to a transfer of property to an investment company. This determination is made using the factors under §351(e)(1).
  + **Reg. § 1.351-1(c)**: A company is considered an investment company if the transfer results in diversification of the transferors' interests, and the transferee is a regulated investment company, a real estate investment trust, or corporation with more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities.
    - This last one wouldn't be a big issue, BUT § 351(e)(1) treats money as stock and securities. The way to avoid this is to ***be sure at least 20% of the assets are not cash or investment stocks***.

## “Boot” in a § 351

* **§ 351(b) Boot with Exchange**: If the shareholder receives property or money, then gain shall be recognized, but not in excess of the amount of money received + the FMV of such other property received.
  + **Shareholder Stock Basis §358**: Here, the basis of the stock will be the carry-over basis of the property exchanged minus the FMV of the property and cash received plus the gain recognized on the transaction.
  + **Shareholder Boot Basis**: The boot’s basis will be the FMV of the boot.
  + **Corporation Property Basis (§ 362(a))**: The corporation’s basis in the property received will be the carry-over basis PLUS the shareholder’s recognized gain.
* ***Also, no loss will be recognized, ever.***
* **Example**: A transfers property to X Corp worth 100k with 10k basis. She gets stock worth 80k and property with FMV of 20k. She’s taxed on the boot she got = 20k gain. A’s basis in the stock would be 10k (original basis) – 20k (FMV of property received) + 20k (gain recognized) = 10k. A’s basis in the property received is 20k. The corporation’s basis in the property received will be 30k.
* **Corporate Tax (§ 351(f))**: If property is transferred § 311 applies. § 311 essentially says it is treated as if the corporation sold the property to the shareholder and is taxed on the gain.
* **Corporation Receiving multiple Assets (Rev. Ruling 68-55)**: If the corporation is receiving multiple assets, they will be treated as multiple § 351 exchanges and the gain recognized to the shareholder will be allocated in basis of the property in the corporation based on the relative FMV of each contributed asset.
* **Example Receiving Installment Note**: What if the shareholder is receiving more boot than recognized gain? Problem Page 79(c). Let's say C is transferring in land with a FMV of 50k and a basis of 20k. In exchange, he's receiving common stock with a FMV of 10k, 5k cash, and an IOU worth 35k. You cannot recognize more than you realize. Although there is 40k boot, there is not 40k of recognized gain. He's only going to recognize 30k gain in the end (§ 351(b)(1)).
  + **When Taxed (§453)**: The default rule of § 453 is that the gain is not recognized all up front - rather, we would get to use the installment method. Prop. Reg. § 1.453-1(f).
    - Not every installment sale is eligible for § 453. Real estate developers cannot use 453 for dealer dispositions.
    - Also, if that asset is publicly traded security, you don't get to use § 453.
  + Assuming §453 applies, the installment method will apply. As each payment comes in, you use the gross profit ratio: Payment x (Gross Profit)/(Total Contract Price).
    - In this example: Payment (5k) x (gross profit (30k))/(total contract price (40k)) = $3.75k
  + **Basis Of Stock**: Here, the IRC treats the shareholder as if they elected out of § 453 installment method to calculate the basis in the stock. The full amount of recognized gain is used. Here, Basis of stock = Basis of property (20k) - fmv of noncash "boot" (35k) - cash received (5k) - recognized loss + dividend + recognized gain (30k) = 10k
  + **Corporation's Basis in Asset (§362)**: Carryover basis from the shareholder plus any recognized gain. The Proposed Regs limit this to whenever the shareholder reports their gain on the installment. So, the corporation here would start with a 23.75k basis as soon as the shareholder receives their first installment.
* **Nonqualified Preferred Stock (§ 351(g))**: Nonqualified preferred stock is treated like boot and is taxed.
  + **Defined § 351(g)(2)(A)**: Preferred stock and one of four elements:
    - (i) Holder has a right to require company to redeem stock.
    - (ii) Company is required to redeem the stock.
    - (iii) Company has right to redeem stock and (as of the issue date) it is more likely than not that such right will be exercised; OR
    - (iv) the dividend rate varies in whole or in part with reference to interest rates or other similar indices.

## Assumption of Liabilities § 357

* When the shareholder is transferring an encumbered asset into a corporation with § 351.
* **General Rule § 357(a)**: If the shareholder receives property in a 351 exchange and the company assumes a liability of the shareholder, then such assumption shall not be treated as money or other property and shall not prevent the exchange from being a good 351.
* **Example**: M is transferring an asset with a FMV of 100k, basis of 20k and mortgage of 5k in a good § 351. Normally, with a regular non-recognition transaction, the mortgage would be considered boot. However, § 357 treats this differently. She has dropped 5k debt, so we reduce her carryover basis in the stock by the mortgage amount. Her basis in this stock would therefore be 5k due to § 358(d).
* **Shareholder's Basis in Stock § 358(d)**: The assumption of liability will be treated as money received. So, reduce the stock basis by any liability assumed by the corporation.
* **Corporation's Basis § 362**: Same as before. Shareholder's Basis (20k) + shareholder's Recognized gain (0k) = 20k.
* **Exceptions**:
  + **Tax Avoidance (§ 357(b))**: If it appears the principal purpose of the taxpayer was to avoid income tax on the exchange or was not a bona fide business purpose, then such assumption shall be considered as money received by the taxpayer on the exchange.
    - *Example*: shareholder takes out loan on the asset the day before incorporation and uses those proceeds for something not related to the business.
  + **Liabilities in Excess of Basis (§ 357(c))**: If the liability is greater than the basis of the asset, then the shareholder will recognize the difference as a gain. ***REMEMBER***: this is done on an **aggregate** basis - so, if you can balance this out, you won't recognize this difference.
    - *Example*: Same case, except the mortgage is 50k instead of 5k. The shareholder will recognize 30k capital gain here. The corporation will now get a 50k basis in the asset (20k + 30k).
    - **Peracchi Case**: What if the shareholder drops in an IOU alongside the property? The court here sides with the shareholder because of the reality of the note. This should be enough to cancel out the § 357 problem. However, this must be a real note and there should be no suspicion that the note will disappear. Make a clear record of the debt and actually pay it (payment schedule and make payments).
  + **Not Real Liabilities (§ 357(d))**: A recourse liability will be treated as having been assumed if the transferee has agreed to and is expected to satisfy such liability. A non-recourse liability is treated as assumed by the transferee of any asset subject to such liability.
    - This is to shut down liabilities that the corporation has agreed to pay but isn't actually expected to pay.
  + **Deductible Liabilities (§ 357(c)(3))**: If a corporation is assuming a shareholder's liability and they are on the cash method and they would be able to deduct it, then the liability is excluded in determining the amount of liabilities assumed.

## Incorporation of a Going Business

* Let's say you have an on-going business that has receivables.
* Regardless of the doctrine that you cannot assign income, this will still be considered a good § 351 transaction.
* **Rev. Ruling 95-74**: You can deduct liabilities that are assumed when incorporating a going business. This is technically a violation of the assignment of income doctrine.

## Contributions to Capital § 118

* **Contributions to Capital**: This occurs when the shareholder contributes property to a corporation and doesn't receive any stock or other consideration in exchange.
* § 351 does not apply to capital contributions.
* **Shareholder Tax Consequences**: Contributing shareholder doesn't recognize any gain or loss on a contribution of property other than cash to a corporation. Instead, the shareholder may increase the basis in her stock by the amount of cash and the adjusted basis of any contributed property.
* **Corporation Tax Consequences**: The contributions are also excludable from the gross income of the corporation. The corporation's basis in the property received is the same as the transferor's basis.
* **Single Shareholder or Pro-rata Contribution**: If the contributing partner is the sole shareholder or if each shareholder contributes property proportionate to their share, the issuance of stock has no economic effect. Such contributions are therefore constructive § 351 exchanges.

## Avoiding § 351

* § 351 is not elective. A shareholder might want to avoid a § 351 if they are contributing property with a loss. Or, if the corporation will soon sell the asset, you might want to recognize the gain at the shareholder level so you avoid the double taxation.
* To avoid § 351, simply sell the asset to your corporation - be sure to take out cash.
* Example: M is a sole shareholder and wants to get property into the corporation but take the gain beforehand. One thing she could do is to sell the property to the corporation. However,t he corporation would need to have the cash to do this. § 267 might apply.
* **No Loss Selling to Related Persons §267**: Generally, you cannot take a loss when you sell an asset to a related person. 267(b)(2) indicates that loss cannot be taken on a sale between an individual and a corporation which is owned more than 50% by the individual.
  + So, the individual would have to own 50% or less of the corporation to take the loss. Stock owned by family members is treated as owned by you.
* There might also be difficulties if other people are trying to take a § 351 transaction. The IRS will argue that this was part of the 351 exchange. However, as long as she doesn't take stock, she won't be considered part of the 351.
* **Gain will be Ordinary if Depreciable in hands of Transferee § 1239**: Generally in the case of a sale or exchange of property, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation.
  + **Land** is not depreciable, so it would not apply to a transfer of land.
  + Also, be sure that the corporation is paying FMV - if the corporation isn't paying FMV, the IRS will argue that there was a constructive issuance of stock and will be a 351 exchange.

## Organizational and Start-Up Expenses

* **Organizational Expenditures § 248**: Expenditures which are:
  + 1) incident to the creation of the corporation,
  + 2) chargeable to capital account, AND
  + 3) of a character which, if expended to create a corporation having a limited life, would be amortizable over that life.
  + Examples: legal fees for drafting the corporate charter and bylaws, fees paid to the state of incorporation, necessary accounting services
    - Specifically excluded: costs of issuing or selling stock and expenditures connected with the transfer of assets to the corporation.
* **Start-up Expenditures § 195**: Expenditures that the corporation could have deducted currently as trade or business expenses if they had been incurred in an ongoing business.
* Corporations may elect to deduct up to 5k in organizational expenditures and start-up expenditures in the taxable year in which the corporation is formed. This 5k is reduced by the amount by which total organizational expenditures exceed 50k.
* Organizational expenditures that are not currently deductible must be amortized over the next 15 years.
* **Problem Page 113**: B is an investor. A owns a sole proprietorship business. A negotiates with B to form a corporation of the proprietorship. They calculate the proprietorship to be worth 510k. B agrees to contribute 490k for a 49% interest in the new corporation and A will own the remaining 51% by contributing the proprietorship's assets and liabilities. What are organizational expenditures and either currently deductible or amortizable under §248?
  + A) 3k in fees paid by A to appraise proprietorship - personal expense that can be added to the basis of the stock.
  + B) What if appraisal fees are paid by corporation? This will be treated as an assumption by the corporation of A's liability. This will be governed by § 357 and 358(d).Unlikely that 357(b) would apply and without more facts 357(c) doesn't apply.
  + C) Legal fees paid by corporation for the following:
    - Drafting articles of incorporation, by-laws and minutes of first meeting. If the corporation makes the § 248 election, the expenses are deductible up to 5k subject to reduction if total expenditures exceed 50k. Rest is amortized over 15 years.
    - Preparation of deeds and bills of sale transferring A's assets to corporation. Costs of acquiring the specific assets and are added to the basis of the properties.
    - Application for a permit from the state commissioner to issue stock and other legal research for securities. Expenses related to securities are not considered organization expenditures and are not added to basis of any asset. They are nondeductible capital expenditures.
    - Preparation of a request for a § 351 ruling from IRS. § 212(3) does not allow a deduction because it only applies to individuals. It is likely more appropriately treated as an organizational expenditure under § 248.
    - Drafting a buy-sell agreement providing for the repurchase of shares by the corporation if either A or B dies. Organizational expenditure under § 248.
  + D) What if A paid all these expenses? This will be treated as a transfer to the corporation and A's basis in the stock will increase. Corporation will be able to amortize these expenses as if it had paid them directly.

# Capital Structure

## Debt vs. Equity § 385

* Factors Considered
  + **Form**: Does it looks like debt? Principal, interest and payment schedule, unconditional payment, shouldn't depend on corporation profits.
    - **Interest Rate**: The interest rate should be the market rate. If it's too low it might look too favorable to be a regular creditor.
    - **Payable Only From Profits**: If it's payable only out of profits, this will look more like equity.
  + **Debt/Equity Ratio**: The higher this ratio is, the more likely this will be classified as equity. 5-10:1 debt:equity ratio probably works.
  + **Intent of Parties**: Objective conduct and facts that prove that people really did consider this to be debt. Course of conduct can show intent.
  + **Proportionality**: If the shareholder's debt is proportional to their stockholdings, this looks suspicious. The idea is that proportional holders won't aggressively defend their debt positions since everyone is proportionally in the same position.
  + **Subordination**: If the debt is subordinated debt.
    - Shareholder Guarantees: If the shareholders are jointly and severally liable for other debt, this will look less subordinated because they will be on the same level as the bank.
* § 385 indicates there are factors to look at - the proposed regs, however, were withdrawn, so there are no clear-cut lines.

## Character of Gain or Loss on Corporate Investment

* You look to the nature of the asset in the hands of the taxpayer before the sale. (§ 1221)
* A capital gain is a gain on sale/exchange of a capital asset.
* Gain on Stock is a capital gain except for broker-dealers selling to customers.
* **Gain on Sale of Qualified Small Business Stock § 1202**: For an individual other than a corporation, gross income shall not include 50 percent of any gain from the sale or exchange of these stocks held for more than 5 years.
  + Available for up to 10 M of recognized gain per qualifying corporation.
  + The issuing corporation must have less than 50M gross assets at the issuance of stock.
  + **Rolling Over Gains § 1045**: Also, § 1045 allows non-corporate shareholders to elect to defer otherwise taxable gain from a sale of qualified small business stock held for more than six months by rolling over the proceeds into new qualified small business stock within 60 days of the sale.
* **Losses on Stock**: These are capital losses unless you're a broker or trader making an election.
  + **Exception § 1244**: Ordinary loss on sale or worthlessness if you're dealing with "section 1244 stock. The requirements are:
    - Must be a "Small Business Corporation"
    - Issued for money or property only
    - Five-year look back test from time of loss - morethan 50% must be coming from active sources and must be an active business five years prior to selling the stock.
    - Original holder only
    - Limited to 50-100k per year.
  + Worthlessness: If the asset becomes completely worthless, you can take your loss at that point. Stock and debt take different paths here:
    - **Stock § 165(g)(A)**: capital loss.
    - **Most Debt is NOT § 165(g)(C)**: This only applies to certain debt. When a bond is in registered form, the corporation is keeping registry of the bonds. If these are the terms, then it will be treated as a security. This likely won't happen today, instead they will be non-securities and thus not covered by 165(g).
    - **Most Debt § 166**:
      * Business bad debt is ordinary loss
      * Non-business bad debt is capital loss

# Nonliquidating Distributions

## Distributions in General § 301

* (a) In general, a distribution of property made by a corporation to a shareholder with respect to its stock shall be treated as provided in (c).
* (c) Creates a three tier system:
  + **1) Dividend**: Any portion that is a divided is entirely gross income. 1(h)(11) still makes this taxed at the capital gains rate, however there is no basis offset. (Defined by § 316)
  + **2) Amount applied against basis**: If the shareholder has basis in the stock, the remaining portion of the distribution will be applied against the basis in the stock and reduce the basis of the stock by that amount.
  + **3) Amount in excess of basis**: If there is still more remaining after step 1 and 2, this will be treated as gain from the sale or exchange of property.
* **Property Defined § 317(a)**: Property means money, securities, and any other property EXCEPT stock in the corporation making the distribution or rights to acquire such stock.
* §301 does not apply to:
  + Distributions of its own stock
  + Distributions in corporate liquidation
  + Redemptions (buybacks) of stock
  + Payments of principal or interest on debt
  + Compensation for personal services
  + Purchase of property from shareholder

## Dividends and Earnings and Profit § 316

* **§ 316 defines dividend** as any distribution of property made out of the corporations E&P. It splits these up into **accumulated E&P** and **current E&P**.
* Distributions made out of E&P are taken out of the most recent E&P first.
* E&P are not eliminated when stock is sold. So, it doesn't matter whether the E&P were earned while the shareholder owned the shares or not.
* § 312(a): Except as otherwise provided, the E&P of the corporation will decrease by the sum of:
  + 1) the amount of money
  + 2) the principal amount of the obligations of such corporation; AND
  + 3) The adjusted basis of the other property so distributed.
  + [In summary, anytime a dividend is paid, the E&P is reduced by that amount.]
* **Special Rules**:
  + **Dividends from one corporation to another (e.g. subsidiary to parent) § 243**: While this is treated as gross income, they get to deduct most of or the entire dividend.
  + **Distributions by S Corporations**: Special rules apply here.
* What is E&P: Roughly, you start with the corporation's income statement then:
  + Add back certain exclusions such as tax-exempt bond interest
  + Add back certain deductions such as dividends received from another corporation
  + Deduct certain items normally not deductible such as federal corporate income tax and previous dividends paid by corporation
  + Special timing rules: depreciation is slowed down and no LIFO inventory even if you use LIFO for everything.
* **Computing E&P During Middle of Year (Rev. Rul. 74-164)**:
  + **Situation 1**: At the beginning of the year, the Corporation has an accumulated E&P of 40k. For the current year, it had a 50k operating loss for the first 6 months, and then ended up with a 5k operating profit by the end of the year. Company distributes 15k dividends at the 6mo mark. At the moment of distribution, the company had -10k E&P. How much of this 15k is a dividend? Here, the entire distribution is considered a dividend. Under § 312, once a dividend is taxed to the shareholders, the E&P goes down by that amount. So, the accumulated E&P here would become 30k.
  + **Situation 2**: The company starts the year with a negative accumulated E&P of -60k. The first 6mo, the company had an operating income of 75k. Then a 15k dividend is paid out in the middle of the year. However, by the end of the year, the current E&P dropped to only 5k. According to § 316(a)(1), we apply the current year's E&P first. The rest of the distribution will be treated as a return of the stock basis.
    - **Multiple Dividends (Reg. § 1.316-2(b))**: What would happen if instead of one distribution in the middle of the year, we had 2 distributions during the year. The first was 12k and the second 3k. They are split - all distributions are treated equally. The 12k distribution will be 4k a dividend and the 3k distribution will be 1k of dividend. Remember - this only applies to current E&P. Accumulated E&P is applied on a first distribute, first applied basis.
  + **Situation 3**: Same as situation 1 but the company had a deficit in E&P of 5k throughout the year. According to the rev. ruling, we take the pro-rata portion of the current years operating loss and apply it against the accumulated E&P. Here, the 5k operating loss is pro-rated to the time of the distribution. It happens to be in the middle of the year, so that's exactly half. So 40k (accumulated E&P) - (5k x ½) (prorated current E&P) = 37.5k. This doesn't help in this situation because the distribution is less than this amount and the entire distribution is a dividend. **Reg. § 1.316-2(b)**.
    - The reg. indicates that this only applies if the actual E&P cannot be shown - so if you can show actual E&P deficit, then you should be able to use that E&P rather than the prorata.
  + **Situation 4**: Same as situation 1 except that the corporation had a deficit in E&P of 55k for the entire current ear. The Rev Ruling says you can apply the prorated amount of the current year's operating loss to the accumulated E&P: 40k - 55k x ½ = 12.5k. Therefore, 12.5k of the distribution will be a dividend and the remaining will be a return of stock basis.

## Distributions of Non-Cash Property

* **FMV of Property § 301(a)(1)**: Distribution is equal to the FMV of the property distributed
* **Shareholder's Basis in Property Received §301(d)**: FMV of the property at the time of distribution.
* **Tax for Corporation §311**: Corporation is taxed on the gain. (a) states that no gain or loss recognized in a distribution with respect to its stock. However, (b) states that gain shall be recognized to the corporation as if such property were sold to the distributee at FMV.
  + **S-corporations** suffer this same fate - they don't pay any tax, but the gain flows through to the shareholders.
* **No E&P?**: Doesn't matter - by virtue of doing this distribution, it will have E&P equal to the FMV of the property.
* **Property with Liabilities**:
  + **Shareholder**: §301(b)(2) - the distribution is reduced (not below zero) by the amount of any liability of the corp. assumed by the shareholder and the amount of any liability to which the property received by the shareholder is subject to immediately before the distributions.
  + **Corporation**: § 311(b) It's still treated as if the corporation sold the property to the shareholder.
* **Loser Property**:
  + Shareholder: Shareholder's distribution is the FMV of the property
  + Corporation: The loss is not recognized by the corporation under § 311(a). However, § 312(a)(3) lets the corporation reduce its E&P by the full basis of the property.
* **Corporation's Own Obligations**: §311(b)(1)(A) carves out the corporation's obligations, so it is not taxed on this. So, instead § 301 applies. This does trigger immediate gain at the shareholder level equal to the FMV of the obligation. There's no sale or exchange, so you CANNOT use the installment method.

## Constructive Distributions

* Payments on "debt"/equity on a purported debt that is reclassified as stock for tax purposes
* Excessive compensation paid to shareholder/employees - if you have shareholder employees, on a reasonable allowance for salary will be deductible by the corporation.
  + §162(a)(1) - corporation can take a reasonable allowance for salaries and bonuses for services actually rendered. The excess can be reclassified as a distribution (§ 310) and the corporation cannot deduct that.
  + This can also happen if they are over-compensating an employee who is related to a shareholder. 162 won't allow a deduction for an unreasonable salary here.
* Personal use of corporate assets. Uses of corporate assets are constructive distributions. So, you have to document a proper purpose for this in order to be a salary and thus deductible.
* Low-Interest loans by corporation to shareholder: IRC § 7872
  + If market interest is not being charged, a bunch of constructive transactions happens. Let's say we have a 100% shareholder of a corporation - he borrows money from corporation by signing an IOU with below-market-rate interest. We're going to make believe that the loan bore a market-rate interest and that the forgone interest is treated as transferred from the corporation to the shareholder (as a dividend) and then immediately transferred back to the corporation as interest. ***So, the shareholder has dividend income, and the corporation gets interest income equal to the difference in payments had the loan been at market rates***.

# Redemptions and Partial Liquidations

## Redemptions Generally §302

* § 302(a) If a corporation redeems its stock such redemption shall be treated as a distribution in part or full payment in exchange for the stock. However, you must meet the requirements of (b) or it will simply be considered a distribution under §301.
* **Definition of Redemption of Stock §317(b)**: Redemption if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.
* § 302(b) Requirements: See the code.
  + (1) Redemptions not equivalent to dividends.
  + (2) substantially disproportionate redemption of stock.
  + (3) termination of shareholder's interest. OR
  + (4) redemption from noncorporate shareholder in partial liquidation.
    - Shareholder cannot be a corporation; AND
    - Distribution must be in relation to partial liquidation of the distributing corporation. (Such as discontinuing a major portion of the business).
* **Redemption and Sale**: You simply compare the before with the after rather than separately for each transaction. This helps shareholders because this can be considered part of their reduction of interest.
  + **“Zenz” Transaction**: If a shareholder redeems shares and sells some in an “integrated plan”, the proper way to analyze the reduction of interest is after everything.

## Complete Termination § 302(b)(3)

* Applies when one shareholder is completely terminating their interest while the company continues. Doesn’t apply if there’s only one shareholder – that would be a complete liquidation of the company.
* Must look to § 318 for attribution of ownership rules that apply here.
* If the attribution of ownership rules apply and it ends up not being a complete termination, the distribution is a dividend and the basis of those shares shifts over the shares of the related parties.

## Constructive Ownership of Stock § 302(c)

* § 302(c)(1) indicates that § 318(a) applies when determining the ownership of stock for this section.
* **Attribution of Ownership § 318(a)**:
  + **Operating Rules § 318(a)(5)(A) and (B)**: Double attribution is allowed EXCEPT for double family attribution.
  + **Members of Family § 318(a)(1)**: spouse (unless divorced), children, grandchildren, parents.
  + **Attribution From Entities to Individuals § 318(a)(2)**:
    - **(A) From Partnerships and Estates**: Stock owned by or for a partnership shall be considered as owned proportionately by its partners or beneficiaries.
      * **§ 318(a)(5)(E)**: S Corporations are treated as partnership for this section.
    - **(B) From Trusts**: Stock owned by or for a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. (“Distributional Percentage”)
    - **(C) From Corporations**: If 50 percent or more in value of stock in a corporation is owned by a person, such person shall be considered as owning all of the stock owned by that corporation in the proportion of their ownership. Anything less than 50% ownership, and there’s no attribution.
  + **Attribution From Individuals To Entities §318(a)(3)**:
    - **(A) To Partnerships and Estates**: Stock owned by a partner shall be considered as owned by the partnership.
    - **(B) To Trusts**: Stock owned by beneficiary shall be considered as owned by the trust unless the beneficiary’s interest is 5 percent or less of the value of the trust.
    - **(C) To Corporations**: If 50% or more of the value of the stock in a corporation is owned by an individual, such corporation is considered as owning the stock owned by that person.
  + **Sideways Attribution § 318(a)(5)(C)**: Let’s say B and C each own 50% of two C corps. C redeems all of his shares in one corp. (a)(5)(C) prevents this sideways attribution.
  + **Option Attribution § 318(a)(4)**: If you have an option to acquire stock, congress assumes that you’re going to act on those and are treated as owning that stock here.
    - **Option Rule in Lieu of Family Rule § 318(a)(5)(D)**: If attribution through paragraph 1 or 4, they are treated as owned under (4).
* **Waiver of Family Attribution § 302(c)(2)**: The taxpayer can take certain steps to be sure family attribution doesn’t apply. You must really be terminating your interest and getting out of the company. If you meet these requirements, the 318(a)(1) family attribution doesn’t apply. Requirements:
  + **Forward Looking**:
  + **§ 302(c)(2)(A)(i)**: Redeemer has no interest in the corporation (including an interest as officer, director, or employee) other than an interest as a creditor.
    - if you’re getting paid for services rendered, you have failed to meet this requirement – *Lynch*
    - Being a landlord with a lease at a fair rent is okay per Rev. Rul. 77-467.
  + **§ 302(c)(2)(A)(ii)**: Redeemer cannot acquire any interest (other than by inheritance) within 10 years from the date of such distribution; AND
  + **§ 302(c)(2)(A)(iii)**: Redeemer must agree to notify the Secretary and retain records.
  + **Backward Looking**:
  + **§ 302(c)(2)(B)(i)**: Any portion of the stock redeemed was acquired within the 10 year period prior from a person whose stock would be attributed to the distribute under 318. OR
  + **§ 302(c)(2)(B)(ii)**:Any person owns stock which is attributable to the distribute and such person acquired the stock from the distribute within the 10 year period prior.
    - **Rev. Rul. 77-293**: If you’re retiring and you give a bunch of stock to his kids, this will still be a good § 302(c)(2) waiver of family attribution.
* **Entity Waiver of Family Attribution § 302(c)(2)(C)**: An entity can waive family attribution only if it’s a complete termination.
  + Example 1:
    - Let's say we have a corporation owned partly by a daughter and an estate.
    - The sole beneficiary of the estate is the mother
    - The estate wants to redeem its stock
    - Under 318(a)(1) the daughter's share is attributed to the mother
    - Under 318(a)(3) they are then attributed to the estate;
    - So this estate constructively owns the shares that the daughter owns.
    - So, this estate must get a waiver to use its basis; otherwise it will be a dividend.
    - So, this estate and the mom would have to sign a § 302(c)(2)
    - Only family attribution can be waived.
  + Example 2:
    - Mother is sole beneficiary of Estate
    - Mother and Estate each own half of a corporation
    - §302(c)(2) doesn't work because the attribution is not a family attribution

## Substantially disproportionate Redemptions § 302(b)(2)

* **Three Tests**:
  + **Substantially Disproportionate**: This test looks at the ratio of the voting stock owned / total voting stock (after the redemption) against the ratio of the voting stock owned / total voting stock (before the redemption) to see if it’s less than 80 percent. ***Look at shareholders percentage of voting power after the redemption - it must be less than 80% of the voting power it had before the redemption.***
  + **Limitation**: The shareholder must own less than 50 percent of the voting power after the redemption.
  + **80% Reduction of Common Stock As Well**: Further, there must be an 80 percent reduction of common stock owned by the redeemer.

## Redemptions Not Essentially Equivalent to a Dividend § 302(b)(1)

* Davis Case: Congress is looking for a “meaningful reduction of shareholder’s proportionate interest.”
* **Rev. Rul. 75-502**: A owns 750 shares of C Corp. B owns 750 shares of C Corp. and Estate owns 250 shares of C Corp. A is sole beneficiary of Estate. Here the estate constructively owned 1000/1750.
  + It then turned in all 250 shares. Here we have attribution from the beneficiary to the estate. How many shares does it own after the attribution. Constructively, it was a controlling shareholder. It is not a good 302(b)(2) because it's not less than 50%. It's right at 50% though. Isn't this a meaningful reduction of the shareholder's interest? In effect, she, as a practical matter, was a controlling shareholder. She had the right to outvote B on everything - the board would be controlled by her and her family. But after the redemption, that's not the case. They are in a deadlock position - they both now own 50% of the corporation. This is a serious change in the control of the company. This is a good §302(b)(1).
  + **IRS Held**: Reduction of voting common stock from 57 percent to 50 percent was meaningful where the remaining stock was held by a single unrelated shareholder.
* **Rev. Rul. 75-512 (Page 232)**: Whole family tree of people who owned the company. The transaction at issue was a trust redeeming all of its shares. The trust constructively owned 30% of the company. They redeem all 75 of the trust's shares, so immediately after the redemption, it owned ~25% of the corporation. The IRS said that this was a good §302(b)(1).
  + **IRS Ruling**: A reduction from 30 percent to 24.3 percent was meaningful because the redeemed shareholder experience a reduction in three significant rights: voting, earnings and assets on liquidation.
  + **IRS Ruling**: A reduction in common stock ownership from 27 percent to 22 percent was meaningful where the remaining shares were owned by three unrelated shareholders because the redeemed shareholder lost the ability to control the corporation in concert with only one other shareholder.
* **Rev. Rul. 85-106 (Page 229)**: There was no controlling shareholder - there was a whole bunch of shareholders with small portions of shares. The trust here had almost as much control as everyone else. The point here was that there was no controlling shareholder - they had as much say as anybody else did. Also, the redemption was of nonvoting shares. There's been no meaningful reduction of the shareholder's interest. This was NOT a good §302(b)(1).

## Partial Liquidations § 302(b)(4)

* Shareholder cannot be a corporation; AND
* Distribution must be in relation to partial liquidation of the distributing corporation. (Such as discontinuing a major portion of the business).
* **§ 302(e) Partial Liquidation Defined**:
  + **(1)(A)**: Distribution cannot be essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level); AND
  + **(1)(B)**: The distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.
  + **May be Pro rata § 302(e)(4)**: It doesn’t matter if the redemption is pro rata as long as it’s a genuine contraction of the corporation’s business.
* **§ 302(b)(4)**: There must be a plan (“formalities”). A partial liquidation can succeed under two tests:
  + **Judicial Test**: “Genuine contraction of the corporate business.” They can even be distributing assets out in kind with the shareholders.
  + **Statutory Safe Harbor § 302(e)(2)**: Cessation of a corporate business AND corporation must conduct a business after the distribution.
    - Note: A mere distribution by parent corporation of its subsidiary’s stock is not enough.

## Consequences to the Distributing Corporation

* § 311(a) and (b) apply.
* If the corporation redeems shares using its own property, the distributing corporation will recognize it
* Corporation cannot deduct redemption price or related expenses: IRC § 162(k)
  + Before this section was added, one corporation managed to take a deduction for the expenses of redemption and the money paid to the shareholder
* If you have a redemption that passes 302(b) (not a dividend) you still get to reduce the corporations E&P (IRC §312(n)(7))
  + It is reduced by a % of stock redeemed; OR
    - If 20% of the stock is redeemed, 20% of the E&P is removed
  + Amount of distribution, whichever is LESS.

## Redemptions through Related Corporations § 304

* **§ 304(a)(1) Acquisition by Related Corp (other than subsidiary)**:
* Stop people from playing the following game:
  + Single shareholder owns X corp and Y corp (100 shares in each corporation).
  + Each corporation has huge E&P
  + If he tries to redeem any shares it will be a dividend and he can't use his basis
* What if sells 60 shares of X corp to Y corp?
  + The idea is that this is a sale.
  + This doesn't work under **§304(a)(1)** - instead, it's treated as a redemption.
  + This is turned into a redemption of Y shares. This brings 302 into play.
  + **ALSO, § 304(b)(2)** says you use the E&P of BOTH corporations when determining the tax treatment of the redemption. E&P of the redeeming company first.
* **§ 304(a)(2) Acquisition by Subsidy**:
* Let's say A owns P corp
* P corp owns 100% of S corp.
* What if he sold some stock of the parent to the subsidiary?
* This is §304(a)(2). Such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

## Redemptions to Pay Death Taxes §303

* In General (a): A distribution of property in redemption of part or all of the stock in determining the gross estate of a decedent shall be treated as a distribution in full payment in exchange for the stock so redeemed.
  + **Limitation of What’s Treated as Redemption**: Shall not exceed the sum of the estate, taxes imposed because of decedent’s death and the amount of funeral and administration expenses allowable as deductions.
  + **35% Value Requirement (b)(2)**: The value of the stock must exceed 35% of the value of the entire estate.

# Stock Dividends and Section 306 Stock

## Stock Dividends and Splits

* STOCK DIVIDEND EXAMPLE: Let's say we have 50k total stock. The common stock is 20k and the earned surplus is 30k. When a stock dividend occurs, they take some money out of earned surplus and put it into the common stock. So, if they issue another 20k in common stock, the common stock amount would jump to 40k and the earned surplus drops to 10k.
* STOCK SPLIT EXAMPLE: Let's say we have 50k total stock. The common stock is 20k and the earned surplus is 30k. When a stock split occurs, then we cut the stated value in half and double the shares outstanding. This doesn't change the numbers in the dollar column, but now, each stock is worth half and there are twice as many.
  + Companies do stock splits to lower the market price per share so that smaller investors don't feel inhibited.
  + However, they've done studies, the day after a stock split, the stock value does actually go up overall.

## Taxation of Stock Distributions § 305

* **(a) Generally**: Gross income doesn’t include the amount of any distribution of the stock of a corporation made by such corporation with respect to its stock.
* **(b) Exceptions**: Shall be treated as a distribution of property to which § 301 applies if:
  + **(1) Distribution in lieu of money**: if the shareholder can choose stock or property.
  + **(2) Disproportionate Distributions**: If the distribution (or series thereof) has the result of
    - (A) the receipt of property by some shareholders, and
    - (B) an increase in the proportionate interest of other shareholders.
  + **(3) Distributions of common and preferred stock**: if the distribution (or series thereof) has the result of
    - (A) the receipt of preferred stock by some common shareholders and
    - (B) the receipt of common stock by other common shareholders.
  + **(4) Distributions on preferred stock**: if the distribution is with respect to preferred stock. This is because in most cases, the control is changing.
  + **(5) Distributions of convertible preferred stock**: if the distribution is of convertible preferred stock unless you can prove that it won’t end up with one person getting stock and another getting property.
* **Defining Preferred Stock Reg. § 1.305-5(a)**: If the stock has unlimited growth potential, it is not preferred stock. It cannot participate in corporate growth to any significant extent.
* **(c) Certain Transactions Treated As Distributions:** Anything having a similar effect on the interest of any shareholder. Essentially, don’t try to think up clever ways to get around (b).
  + **Example**: Let's say A and B each own 100 shares in C corp. A redeems 80 shares. This is a good 302(b)(2) substantially disproportionate distribution to him. But if 305(c) really means what it says, the IRS could put out regulations saying that this is a dividend and tax B as well. This is exactly a 305(b)(2) because B's share is going up and A is receiving money instead.
    - If you do it as a redemption, you won't get taxed.
    - However, if you do it as a distribution of shares and property, you will get taxed on a dividend under 305(b)(2).
  + **IRS SAYS**: If the redemption is an isolated transaction, we will not raise 305(c). But if it's part of a series of transactions, this will look too much like a dividend (say in the last 2 or 3 years).
  + **Reg. § 1.305-3(b)(3)**: . . . In addition, a distribution of property incident to an isolated redemption of stock (for example, pursuant to a tender offer) will not cause section 305(b)(2) to apply even though the redemption distribution is treated as a distribution of property to which section 301, 871(a)(1)(A), 881(a)(1), or 356(a)(2) applies.
  + **See Reg. § 1.305-3(e) Example 8** - if there are regular installments - it might be treated as a whole bunch of 305(b)(2) redemptions.
* **Corporate Tax § 311**: No gain or loss is recognized to a corporation on distribution (not in complete liquidation) with respect to its stock of its stock.

## § 306 Stock

* § 307(a) says that if a shareholder receives stock in a distribution to which 305(a) applies, then the basis of such new stock and the old stock shall be determined by allocating between the old stock and the new stock the basis of the old stock.
* Essentially, if you dispose of §306 stock, that stock is treated as if it was a dividend from the company. So, essentially, the basis from that stock would shift back into the original stock.
* **Defining 306 Stock § 306(c)**:
  + If it participates in growth, it's common stock.
  + If they don't have a right to participate, then it's a 'preferred' stock for §306.
  + Includes tax-free dividends of preferred stock - (c)(1)(A)
  + Also includes preferred stock received in recapitalization - (c)(1)(B)
    - Shareholders turn in shares and they get new shares of different classes
  + Exception if no E&P at time of issuance - (c)(2)
    - If no E&P, no application at all - the idea here is to capture growth.
* **Taint Remains §306(c)(1)(C)**: anyone who takes that stock with the same basis as you maintains this 'taint'. It remains § 306 stock.
* **§ 306(a)(2)** - if the disposition is a redemption, the amount realized shall be treated as a distribution of property to which § 301 applies.
* **(b) Exceptions**: if you are terminating your interest, it will not be treated as a dividend.
* **Additionally, § 306(a)(1)(A) -** you only have a dividend to the extent that the corporation had E&P when you got the stock.
* **Triggering Events**:
  + Sale of § 306 Stock
    - Entire amount realized is dividend to extent corporation had E&P when stock was issued
    - Any excess is treated as sale - basis allowed for purposes of computing capital gain, BUT NO LOSSES
  + Redemption of § 306 stock
    - Automatically treated as distribution covered by IRC § 301
  + If termination of entire interest, not treated as dividend.

# Complete Liquidations

## Complete Liquidations under § 331

* Distributions in complete liquidation are considered as full payment in exchange for the stock. §301 does not apply in a complete liquidation.
* If a corporation liquidates, the E&P disappears. At the shareholder level, it’s no different than if the shareholder sold his stock to a stranger.
* **Complete Liquidation Defined § 346**: A distribution is treated as a complete liquidation if it is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.
  + **Use of Basis**: Because there’s no way to know how much money will come out (unknown creditors), the IRS lets the shareholders use all of their basis first.
* **Using a Trust to Complete Liquidation**: Sometimes, the shareholders set up a trust for their benefit and the corporation will distribute money to that trust. For tax purposes, a distribution to the trust is taxed as a gain even though the money hasn’t actually been distributed.
* What if the SH receives an **installment obligation** from the corporation in a liquidation? 331 still applies if it’s a liquidation. The taxpayer can use 453 an use the installment method to report gain if he meets the requirements of 453(h). (h) requires that the obligation was received by the company within 12 months after the adoption of a liquidation plan and the plan must be completed within that 12 month period. ***Limitations:*** 
  + You can't use this for publicly traded companies. ***453(k)(2)***
    - He would have his full gain in year one if it was publicly traded.
  + Doesn't apply to notes received before the plan of liquidation.
    - This would instead be treated as FMV of the note.
* What if they just distribute all assets, but then a creditor comes out of the woodwork and A is required to pay 5k 2 years later. What's the tax treatment of that transaction?
  + **Arrowsmith Case**: This is considered a 5k capital loss. This transaction is related back to the source.
* **Basis in Property Received in Corporate Liquidation § 334(a)**: Basis is the FMV of such property at the time of distribution.
  + **What if you get property in a distribution with a mortgage on it?** Only the equity of the property goes into the shareholder's gain. If the shareholder was receiving 8k in cash and 12k property with a 5k mortgage (and he had 10k basis in his shares), he would be treated as realizing 15k. Therefore, he would have a 5k capital gain. The basis in the property would be the full FMV of the property, however. It only makes sense.
* **Corporate Taxation § 336**: Gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation as if sold to the SH at FMV.
  + **S-Corps**: Same thing, though no corporate tax.
  + **Limitation on Recognition of Loss (d)**: No loss is recognized if such distribution to related person is not pro-rata or such property is disqualified Property.
    - **Disqualified Property (d)(1)(B)**: Property acquired by the corporation to which 351 applied or as a contribution during the 5 year period before liquidation.

## Liquidation of a Subsidiary § 332 (Parent) and § 337 (Subsidiary)

* This is a tax free transaction.
* The E&P of the subsidiary goes into the parent corporation.
* The parent’s basis in the stock disappears.
* Requirements § 332(b):
  + (1) The parent must own at least 80% of the stock of the subsidiary from the time of the plan of liquidation through until the actual liquidation. AND EITHER:
    - (2) The Transfer must happen in one taxable year; OR
    - (3) the transfer must be a series of distributions in complete redemption of all its stock that is completed within 3 years from the adoption of the plan of liquidation.
* **Basis of property received § 334(b)**: carryover basis from subsidiary.
* **§ 337 Subsidiary**: No gain or loss recognized to liquidating subsidiary to which § 332 applies.
  + If you have a minority shareholder, distributions are made to the minority shareholder as well - they are NOT covered by 332, 337.
  + The subsidiary recognizes gain here on this sale. Also, the sub can never take a loss in this situation under 336(d)(3).

# Taxable Corporate Acquisitions

## Stock Acquisition

* If P buys the stock of T, this is considered a “stock deal”. This is a taxable sale, so there will be capital gain here. T can then be liquidated into P. However, even though the company was purchased at the full FMV of T, the basis of the assets will remain the same because P’s basis in T’s stock disappears when T liquidates as a sub of P.
* P may liquidate T under IRC §§ 332, 337
  + No gain/loss, carryover basis on asset
* Restrictions on carryover of tax attributes under IRC § 382
  + NOL carryforwards don't get eliminated, but they get slowed down.
    - Companies used to purchase companies with tons of NOL in order to deduct them against gains.
  + §382 says that when a company is sold, the NOL carryforwards are slowed way down - can only be used based on the value of the target company. How much was the T company really worth? You can use the NOL carryfowards at say 3% a year. You can use the NOL to offset the profits from turning that company around. If you dump a bunch of more assets in there, you can't use the NOL against your other asset's gains. Only based on an annual percentage of the assets in the company when you bought the target company.
* **§ 338**: If you do a stock deal, and the purchaser is really unhappy that the basis of the assets didn't step up, you can make an election under 338 to treat the deal as an asset deal. For state law, it will still be a stock deal, but it can be treated as an asset deal. There will be corporate tax, though - why ever do this? You don't. Do not make a 338 election.
  + This MIGHT make sense if the target company was an S corporation or a controlled subsidiary. This is because no corporate tax will be triggered because the liquidation would be tax free anyway. §336(e)
  + You would want to do it in these cases because you would get a stepped up basis for nothing.

## Asset Acquisition

* If T sells all assets to P and then liquidates all of that cash to the shareholders of T, this is an asset acquisition. When T sells their assets, this is a taxable even and T will recognize the gain – you then have all the asset gain taxed at the corporate level. P will then get a stepped up basis in the assets (cost basis). Now, when T liquidates, A will have capital gain on the money remaining in T. This is the double tax nightmare. The good news is that P will get a stepped up basis in the assets. But, why pay corporate tax now for basis later? From a present value standpoint, this is worse.
  + One point would be to purchase only the assets without the potential liabilities of the corporation. Although, sometimes the liabilities come with the assets and even some states indicate that product liability can come with the purchase.
* Gain is calculated on an asset by asset basis
* Seller's concerns
  + If assets are capital gains assets, more of the sale price will want to be for these assets
* Buyer's concerns
  + Buyer wants to put as much basis as possible for inventory and other ordinary income type assets (and depreciable assets)
  + Amortization of intangibles (***IRC §197***) - (i.e. goodwill of the business, non-compete agreements, going concern value) this is depreciated over 15 years. If you purchase intangibles in this situation, they have to be amortized over these 15 years. As a buyer, you don't want the basis here - this is 15 years of straight line depreciation.
* Allocation of price
  + Buyer's and seller's allocations must match
  + **IRC §1060**: If you have an agreement as to the allocation, they have to use that on their tax return. The IRS doesn't have to accept this, but the parties are bound by it for tax purposes. Default rule (no contract): see below.
* **IRC § 1060**:
  + Parties bound by their contractual allocation for tax purposes
  + If no allocation in contract, must use "residual" method of allocation
    - Tangible assets should be allocated first based on their actual FMV values, intangibles get what's left over
  + Both parties must report allocation on particular IRS form
    - Easy for IRS to compare
    - IRS will check to make sure allocations are somewhat close.

# Reorganizations

## Reorganizations (Ch 9-12)

* Have one company acquired by the other without anyone paying any taxes.
* This could be a company splitting into multiple corporations
* **Statutory Merger**: We've got T, a corporation with valuable assets (400k FMV). Corporation P wants T's assets. Let's assume that A (shareholder of target company) is willing to accept stock of P as consideration for the deal. If he's willing to accept this as consideration, you can have P take over T and it will be taxfree to everybody.
  + Most of the consideration that A is getting must be P's stock. If P's a publicly traded company, this isn't much of a risk.
  + This is considered a statutory merger. T goes out of existence and all of the assets and liabilities of T go to P.
  + If A does get cash in addition, that cash would be boot and it would be taxable. But, the stock won't be.
  + If A gets all cash, it's a taxable deal - not a reorg. The shareholder is shielded by §354.
  + § 362 - P takes assets with a carryover basis.
  + § 358 - The shareholder gets the stock in P with a carryover basis from their old stock.
  + § 382 - anytime a corporation changes ownership - any loss carryovers get slowed down.
  + The E&P does not disappear - it carries over to the surviving corporation.

## § 361 - Corporations in a Reorganization

* (a) General rule: No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

## § 354 - Shareholders in a Reorganization

* (a) General rule (1) In general: No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

## In order to be a Reorganization:

* Fit into one of the seven "types" in IRC § 368(a)
  + (A) Statutory merger/consolidation
  + (B) Stock for stock - p exchanges stock in P for T's stock - this is a B-reorg. It must be SOLELY for voting stock of P. No Boot is allowed.
    - Not a merger or acquisition, but roughly the same.
    - This is if T's board of directors won't do the merger. P can make an offer enough to get 80% of T's stock in exchange for stock in P>
  + (C) Stock for Assets
    - Here, P issues its stock in exchange for all of the assets of T and then T liquidates and distributes all the P shares to the shareholders of T. The majority of what the shareholder gets must be voting stock.
  + (D) Corporate divisions (and others)
    - Allows you to split one corporation into two (main D reorg - a divisive reorg)
    - Let's say we have a corporation engaged in two businesses and it splits the businesses into two corporations. You can achieve this split and have it be tax free to the shareholders. There are three different formats:
      * 1) "Spinoff": Corporation forms a new subsidiary, drops one of the businesses into the subsidiary in exchange for stock in new corp. Then, parent distributes out stock of the subsidiary to its shareholders
      * 2) "Splitoff": Same - but instead have shareholder turn in stock as part of the deal.
      * 3) "Splitup": Corporation forms 2 subsidiaries then liquidates itself and distributes the shares of subsidiaries to its shareholders.
    - § 355 rules as well must be met.
    - Boot is allowed, but it is taxed.
  + (E) Recapitalization - existing shareholders exchange shares for new shares
    - Boot is allowed, but taxed
  + (F) Migration: Mere change in identity, form: changing where your company is filed
  + (G) Bankruptcy Reorganization -
* Must meet three judge-made tests:
  + Continuity of shareholder interest (COSI) - target-company shareholder must be mostly getting stock
  + Continuity of Business Enterprise (COBI) - assets of target company must still be around and employed in a business in a transaction
  + Business purpose requirement (easy to meet)
* If not a reorganization, acquisition is taxable (chapter 8).

## § 368(a)(2)(E) Triangular Mergers

* Do this if the end goal is for T to become an entirely new subsidiary of P. P would give stock to a newly created subsidiary S. S would then merge T into S. (This can be done in §368(a)(2)(D))
* A "Reverse" would be if S merges into T instead.

# Anti-Avoidance Rules

## Economic Substance Doctrine

* Substance prevails over form.
* It's hard to know whether clients win or use on this issue.
* **United Parcel Service v. Commissioner (619)**: UPS is a successful business. Accountants say - set up a subsidiary in a country with low tax (Ireland today) and farm the insurance part of your business offshore. The subsidiary then makes a portion of your business.
  + They gave the shares in this new sub as a taxable dividend to their shareholders. TO avoid even further, UPS sent the insurance money to a separate company which then pays it to your subsidiary corporation. (Run it through a third party).
  + IRS audits, drags to court, wins in tax court on the theory that this is a sham.
  + Case goes to the 11 circuit - 11 circuit sides with UPS.
  + So...who knows?
* IRS has authority under §482 to recast all transactions between brother-sister corporations as arms-length deals.
* § 7701(o)

## Accumulated Earnings Tax (§ 531)

* If a corporation does not pay dividends, then we start to examine what the corporation has been doing more carefully. In addition to having to pay it's regular corporate tax, it might have to pay this penalty tax.
* A corporation can get subjected to this:
  + Accumulating earnings beyond reasonable needs of business, then we tax on undistributed earnings.

## Personal Holding Company Tax

* If corporation is closely held and most of its income is investment income
* If a corporatino is engaged in supplying services to people and the service provider is the shareholder. This is to stop athletes from forming corporations and supplying themselves through a corporation.
* These are not a problem if you're paying dividends.

# S Corporations

## Generally

* More S-Corps than C-Corps by a wide margin
* Even more S-Corps than partnerships
* **Single-Tax**: When an S-Corporation earns a profit, the corporation is not taxed
* **"Pass-Through"**: The income passes through and ends up on tax returns of shareholders - this is 100% pass through - it doesn't matter if there's a distribution or not - it's taxed immediately upon recognition by the s-corp of the income.
  + Losses also pass through and are not trapped on a corporate tax return
* **Non-tax Distributions**: Distributions are generally not taxed, unlike a c-corp.
* An S-corp does not have E&P (unless they used to be a c-corp)
* 1361: eligibility requirements
  + Be a 'small business corporation"
    - Doesn't have to be small
    - And doesn't have to carry on a business
  + Make an election
    - Even LLCs can check the box to be a corporation and then elect to be an S-Corp
      * They do this so they can revert back to a partnership without having to go through liquidation.
* 1363: says no tax for s-corps
* 1366: says the tax flows through to the shareholders - everything that happens in the s-corp shows up on the shareholder's tax returns

## S Corporation Not Taxed § 1363

* (a) General rule: Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter.
* (b) Computation of corporation’s taxable income: The taxable income of an S corporation shall be computed in the same manner as in the case of an individual . . .

## Shareholder of S Corporation Pass-Thru Tax § 1366

* (a) Determination of shareholder’s tax liability
  + (1) In general: In determining the tax under this chapter of a shareholder for the shareholder’s taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation’s taxable year), there shall be taken into account the shareholder’s pro rata share of the corporation’s—
    - (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
    - (B) nonseparately computed income or loss.

## Eligibility Requirements § 1361

* (a) S corporation defined
  + (1) In general: For purposes of this title, the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under section 1362 (a) is in effect for such year.
* (b) Small business corporation
  + (1) In general: For purposes of this subchapter, the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not—
    - (A) have more than 100 shareholders,
    - (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
    - (C) have a nonresident alien as a shareholder, and
    - (D) have more than 1 class of stock.
  + (2) Ineligible corporation defined: For purposes of paragraph (1), the term “ineligible corporation” means any corporation which is—
    - (A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,
    - (B) an insurance company subject to tax under subchapter L,
    - (C) a corporation to which an election under section 936 applies, or
    - (D) a DISC or former DISC.

## "Small Business Corporation" under IRC § 1361(b)

* Not an "ineligible corporation" (b)(2)
* Domestic corporation
* Requirements (b)(1):
  + Not more than 100 shareholders
    - Spouses and family members are treated as a single shareholder (1361(c)(1))
  + No shareholders who are not individuals
    - Except: decedent's estates, most trusts, pension funds, and charities
    - Except S corporation parent owning 100% of the stock (IRC § 1361(b)(3)): this is a QSub (qualified subsidiary).
    - (c)(6) stock can be with charity
    - Can't have a partnership/corporation as shareholder
  + No nonresident alien shareholders
  + Can only have 1 class of stock
    - Differences in voting rights are ignored

## Election: IRC § 1362

* ***All*** shareholders must consent.
  + You have to be careful with community property laws. In a community property state, each person in a marriage owns half. This means that the spouses would have to consent.
* (b) Election generally starts at the beginning of a taxable year.
  + Can be good for current year if made within 2 and ½ months of start of year
    - The taxable year of the S-Corp doesn't start until it comes into existence.
* The S-Election is good until it is revoked or is terminated.
  + You don't have to get signature of new shareholders.
  + HOWEVER: you need to get consent of everyone since beginning of 2.5 months of start of year. And each shareholder during that period would have to be eligible shareholders.

## Terminating S Status

* Voluntary revocation - IRC §1362(d)(1)
  + Must have more than ½ of shareholders consent
  + If you revoke within the first 2.5 months, you can revoke to the beginning of this year.
  + You can also specify a future date.
* Ceasing to be small business corporation - IRC § 1362(d)(2)
  + Anytime one of the eligibility requirements is not longer fit
  + The timing is effective on and after the date of cessation.
  + You want to sign an agreement to prevent shareholders from screwing this up.
* Some S corps. That used to be C corps. - IRC § 1362(d)(3)
  + This only applies if the s-corp used to be a c-corp.
* Inadvertent terminations - IRC § 1362(f): IRS can forgive if you correct the problem and you must show that it mustn't be on purpose. They have been very generous to grant these.
* Can't go back to Sub S for five years - IRC § 1362(g) - you're allowed to change once, but you cannot change back for five years

## S Corporation Operations

* Under 1366 - income and losses "pass thru" - shareholders must put their pro-rata share of everything that happens in the corporation. It must be on their tax return regardless of a distribution or not.
  + The character (ordinary v capital) is determined at corporate level (1366(b)) and then retains that character when it passes through
  + Any elections are made at a corporate level (e.g. 1033) - this is 1366(c)
    - Shareholders are stuck with it
* When income passes through to the shareholder, their basis on their stock goes up (1367) - same thing with a deduction (basis in stock would come down). For every pass through action there is a basis reaction.
* If it was never a C corporation, distributions are treated as return of stock basis, and then capital gain if it exceeds the basis in the stock (§ 1368(b))
* 1371(c) - s-corporations do not generate E&P while they are S-corps

## Example

* Three shareholders of S corp.
* S corp earns 15k profit
* This 15k profit passes through to shareholder - each shareholder pays taxes on 5k of income
* Now, their basis in their stock goes up by 5k.
* Then, if each shareholder takes 5k out as a distribution, this will be tax free for them
* Then, their basis in their stock goes down by 5k.

## S-Corporation Operations

* Loss "pass-thru" limited to stock basis + debt basis (1366(d))
  + Debt basis = shareholders who are creditors to that company
  + You can't take losses beyond this basis - they carry over to the future if at a later time the corporation earns money and the shareholder gets a basis
  + You can't take losses if you don't have basis
  + This can create problems if the corporation borrows money from third party:
* Corporate debt to third parties does not create usable basis for shareholder ( even if shareholders guarantee it!)
  + Harris (page 679) and many other cases
  + Losses that represent the corporation burning through the bank loan won't pass through to shareholder.
  + So, you might not want to put the owners in an s-corp if they are going to be guaranteeing a loan.
    - Instead - have the shareholders borrow the money and then lend it to the s-corp.

## C-Corps To S-Corps

* Switching over is not a taxable event. Congress could have treated this as a liquidation and formation, but they didn't.
* Electing S is not a taxable event, but:
  + Double tax on appreciated property doesn't go away
  + E&P (dividend potential) doesn't go away
  + If E&P is present, excess passive investment income creates problems
    - E.g. Interest/dividends, rents - the corporation has to pay a tax on that and if it persists, it could terminated S-status under 1362(d)(3)
    - Tax at corporate level
    - Eventual termination of S status
    - The idea here is that they were afraid that there would be a bunch of c-corps that, instead of liquidating to close up shop, they become an S-corp to avoid liquidation taxes and just continue to invest the E&P in a portfolio of passive investments.
* Don't ever be a C-Corp if you're going to be an S-corp.

## Example

* Let's say we have a 100% shareholder of a c-corp that owns a property with FMV of 20k and basis of 11k.
* This property is lobster trapped. What congress doesn't want is for that corporation to make an s-election and then sell that asset to shareholders tax free.
* The corporation will still pay a tax on this asset on the 9k gain.

## Former C-Corps: Appreciated Property

* Can't eliminate corporate tax on asset appreciation inside c-corporation
* § 1374 taxes the s-corporation on "built-in" gain (BIG) that was present when S election was made
* "taint" persists with the corporation for 5 years after S election is made (IRC § 1374(d)(7))

## Former C-Corps: Dividends

* What if you still have accumulated E&P from your c-corp days?
* Distributions of old c-corp. e&P are dividends - taxable to the shareholders
* BUT, previously "passed thru" S-corp. income not taxed.
  + If you take a distribution, you look to previously passed through income and it won't be taxed again - only if they take out distributions beyond the income passed through to them.
* Distributions are treated as previously taxed S corp. income first - "AAA" account (1368(e)(1))
  + The Accumulated Adjustments Account - sum total of all the ups and downs of your share interest
* Distributions beyond AAA are § 301 - taxable to extent of remaining E&P
* Example:
  + C-Corp with $100 E&P - what if we switch over to S-corp and pay $100 out?
  + Is this a dividend?
  + You have to ask - did any income pass through to shareholder? He's entitled to take that much out tax-free first before we use the E&P as a dividend.
  + So, it's tax free to the extent of the AAA account.

## Former C-Corps with E&P And Passive Investment Income

* IRC §1375 - corporation taxed on passive income if it has old E&P
* § 1362(d)(3) - lose S status after three years of that
* Clean out the old E&P before turning old c-corp into s-holding company!!!
* You can clean it out after it becomes an S-corp as well - you can bypass the AAA account if you want to.