RECONSIDERING THE C CORPORATION

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We are in a period of a lot of proposed changes in taxes. We are facing the expiration of the 2001 tax cuts and have seen increasingly proposals to expand FICA or SECA taxation into various S corporation passthrough structures.

One tax entity that is, curiously, not seeing much in the way of pending or proposed negative changes is the Rodney Dangerfield of the small entity, the C corporation. C corporation rates will remain at the same level regardless of whether or not the 2001 tax cuts are extended and taxation of C corporations has actually been an area where discussion of tax relief has even been broached.

C CORPORATIONS IN THE SMALL BUSINESS SETTING

Prior to 1986 C corporations were quite often used in small business settings. C corporations offered (and continue to offer) certain unique advantages not available in other entities. In the pre-1986 Tax Reform Act years C corporations were often used for a number of reasons. Those included:

1. **Availability of lower tax brackets** – Tax rates on corporate income below $100,000 have traditionally been relatively low—allowing a relatively tax favored environment for accumulating capital for a business to be able to finance its own growth.
2. **More favorable employee benefit options** – For many years C corporations offered the ability to create qualified retirement plans that offered owners a much more flexible and generous retirement plan than was made available to unincorporated entities or even shareholders in S corporations. While qualified plans have now become basically comparable, certain other benefits were (and remain) limited to actual employees of the employer. S corporation shareholders lose out on these options due to the 2% shareholder rule found in §1372 that treats such individuals (which includes those deemed to hold the stock under the attribution rules of §318) as being partners rather than employees.

3. **Use of fiscal years to defer taxation** – C corporations could elect any fiscal year they wished, which allowed for deferral of income as the owners would not be taxed on payments for salaries or rents that were made after December 31, allowing to some extent the income to be pushed forward with taxation moved to a year later. Flow entities had limits imposed on their abilities to select fiscal years that simply did not exist in the C corporation arena.
4. **Expected entity for eventual public offering** – If an entity hoped to eventually have a public stock offering and/or wanted to bring in outside money in advance of such a public offering, the C corporation offered the ability to be from the start in the form that would be needed for the public offering.
5. **Ability to escape double taxation on liquidation** – Prior to the 1986 Tax Act, a C corporation that was being liquidated (often due to a sale of its assets) could avoid paying tax on the inside gain by engaging in a tax free liquidation of the assets within 12 months, using a statutory provision that was adopted to codify the *General Utilities* case law. Thus what was the textbook disadvantage of being a C corporation ceased to be a real problem for many closely held C corporation, as their only real exposure to double taxation would take place on a sale when the goodwill of the business would be purchased by the buyer.

However, in the late 1980s the world changed and the C corporation ceased to be a major player in the small business arena. A number of changes impacted this:

1. **Repeal of General Utilities** – Probably the biggest impact came from the 1986 Tax Act's removal of the ability to liquidate the corporation and avoid tax on the inside gain. That change meant that C corporations could not avoid the double tax when sold unless they found a buyer who would take the stock—not something that normally was a buyer's favorite way to proceed, and one that would normally result in the buyer demanding a significant reduction in the purchase price paid.
2. **Built in gains tax and excess passive income tax on S Corporations** – The 1986 Act also imposed a new rule that kicked in a 10 year potential "penalty" period if a corporation elected S status. Similarly, a corporation that elected S and held onto any of the C corporation period earnings and profits became potentially subject to the excess passive income tax and related loss of S status if the problem continued for three years. These two provisions gave incentive to keep an S corporation "clean" and insure it never allowed itself to become a C corporation.
3. **Personal service corporation rules** – The personal service corporation rules eliminated the ability to make use of either the lower corporate tax brackets or the benefit of deferral of income for corporations in certain "tainted" businesses.

4. **Mandatory accrual basis** – The law also now required any C corporation with average revenues of more than $5 million to report on the accrual basis unless it was a personal service corporation (which generally had the problems noted just earlier). That was true even if the corporation was engaged in a business where the use of the cash basis was clearly appropriate. This mandatory accrual rule would not apply to S corporations or partnerships without corporate partners.

The bias against the C corporation in the tax law for small closely held businesses lead to a massive shift from C to S corporation status, a preference that has remained intact to date. However, certain changes and proposed changes may make C corporations more desirable. As well, even without such changes there are still times when a C corporation makes a lot of sense.

In today's session we'll look at why a C corporation may make sense and considerations that may push us towards the C corporation. We also will look some recent developments in the C arena.

WHEN A C CORPORATION MAKES SENSE

A number of fact patterns have continued to argue for considering C status, but sometimes these considerations are forgotten due to the overwhelming preference for passthrough entities. That is, there are times when consideration is mainly given on whether we wish partnership or S corporation treatment only, rather than stepping back and looking at the possibility of C status.

Building Capital to Grow the Business

One of the key advantages of the C corporation that continues to this day is the availability of the lower tax brackets. The C corporation is an entity separate from its owners, and it starts with its own lower tax brackets that can be used to allow the company to self-finance its growth more effectively.

As an example, let us assume we have a business that is owned by an individual that is fairly successful but is looking to grow. The success of the business means that the owner's taxable income each year is pushed up into the tax personal income tax brackets.

Let us assume that the entity looks inside to fund its growth and needs about $67,500 a year to do so. We'll also make a simplifying assumption that in this case income is approximately equal to net cash flow. If the entity is an S corporation all income is taxed to the owner, with tax paid at his/her individual rate. However in a C setting any income retained in the corporation is taxed only at the corporate rates.

We shall look at two cases—first, that the corporation simply retains $75,000 of income as a C corporation and pays tax on that. In the second, there is an S election in place so that amount of income is taxed at the individual level at a higher rate, thus requiring another source of funds to make up the shortfall. We shall assume that it will be borrowed at a rate of 10% from a lender. While it is possible the owner could "absorb" that cost, we would still need to account for the lost earnings on those funds.

Over the past ten years we could look at the difference in the two scenarios. Note the additional effective cost of the borrowing (or lost earnings) in the S situation:

Year	Income	C Corporation Tax	Net Available to Invest (C Corporation)	Indivdiual Tax	Net Available to Invest (S Corporation)	Borrowing	Interest @ 10%	Cumulative Debt
2001	75,000	13,750	61,250	26,250	48,750	12,500	625	13,125
2002	75,000	13,750	61,250	26,250	48,750	12,500	1,938	27,563
2003	75,000	13,750	61,250	26,250	48,750	12,500	3,381	43,444
2004	75,000	13,750	61,250	26,250	48,750	12,500	4,969	60,913
2005	75,000	13,750	61,250	26,250	48,750	12,500	6,716	80,129
2006	75,000	13,750	61,250	26,250	48,750	12,500	8,638	101,267
2007	75,000	13,750	61,250	26,250	48,750	12,500	10,752	124,519
2008	75,000	13,750	61,250	26,250	48,750	12,500	13,077	150,096
2009	75,000	13,750	61,250	26,250	48,750	12,500	15,635	178,231
2010	75,000	13,750	61,250	26,250	48,750	12,500	18,448	209,179
Interest Cost							***84,179***	

While we have the ultimate problem of the lack of the *General Utilities* doctrine should we later sell the assets of the corporation, that second tax will only come into play when we sell, while the interest cost (or implicit interest cost) continues to add up each year as we operate.

The situation grows worse going forward if the 2001 rate cuts are allowed to go away, and the top marginal rate grows to 39.6%. Under that scenario, the next ten years would look like this:

Year	Income	C Corporation Tax	Net Available to Invest (C Corporation)	Indivdiual Tax	Net Available to Invest (S Corporation)	Borrowing	Interest @ 10%	Cumulative Debt
2001	75,000	13,750	61,250	29,700	45,300	15,950	798	16,748
2002	75,000	13,750	61,250	29,700	45,300	15,950	2,472	35,170
2003	75,000	13,750	61,250	29,700	45,300	15,950	4,315	55,435
2004	75,000	13,750	61,250	29,700	45,300	15,950	6,341	77,726
2005	75,000	13,750	61,250	29,700	45,300	15,950	8,570	102,246
2006	75,000	13,750	61,250	29,700	45,300	15,950	11,022	129,218
2007	75,000	13,750	61,250	29,700	45,300	15,950	13,719	158,887
2008	75,000	13,750	61,250	29,700	45,300	15,950	16,686	191,523
2009	75,000	13,750	61,250	29,700	45,300	15,950	19,950	227,423
2010	75,000	13,750	61,250	29,700	45,300	15,950	23,540	266,913
Interest Cost							***107,413***	

The negative of using this tax break is the issue every student learns in his/her first tax course—a C corporation faces a second level of taxation. But that second tax doesn't apply until the corporation either pays a dividend or liquidates.

If the business is a family business with the plan being to pass the enterprise on to the second generation, the "day of reckoning" for the second income tax may never occur—or, perhaps more properly, we get the second tax reset at the date of death.

Even if the tax is paid, if the amount is paid far enough in the future the present value of the tax will be low enough to make the present value of future.

Fringe Benefits

A number of fringe benefits that are granted tax preferred status are available only to employees. In addition to removing the benefit from owners that do not incorporate at all (sole proprietors and partners), S corporation shareholders face the hurdle of §1372. That provides that S corporation shareholders that hold more than 2% of the corporation's shares are treated as if they were partners in a partnership.

Note that some fringe benefits are still available to partners—most importantly, for the purposes of qualified plans and qualified plan like entities (such as SEPs and SIMPLE IRAs). As well, some of those not available likely aren't deal killers—for instance, it's difficult even for a C corporation shareholder to take advantage of benefits such as those for educational benefits or dependent care benefits provided by the employer due to strict anti-discrimination rules that make it extraordinarily difficult to get any significant benefit to the owner.

However, there are a few benefits that may be very available in the right circumstance. For instance, in the case of a C corporation that consists of a shareholder who is the corporation's only employee, a medical reimbursement arrangement under §105(h) (which the IRS began referring to as an HRA in 200) can provide a significant benefit for a shareholder that has significant medical expenses for him/herself, a spouse or a dependent. Under §105(h), the employer can deduct the amounts paid under a qualified reimbursement plan and no amount is included in the income of the employee—but the benefit is strictly limited to employees and not the self-employed [IRC §105(g)].

In the right case it can create a significant tax benefit, as the corporation pays the medical expense and reduces its tax without any corresponding increase in individual tax—even the feared double tax doesn't apply in any manner to this benefit.

> ***Example***: Mary has total adjusted gross income of $500,000 and runs a flower shop. Even if she otherwise is able to itemize deductions, she will have no tax benefit on the first $7,500 of medical expenses paid. If her flower shop is an S corporation, the $7,500 will have to pass to Mary as a distribution generating no corporate deduction, costing her tax of $2,970 in 2011 (39.6% of $7,500). If that shop was a proprietorship things are a bit worse—that flowthrough would also be subject to self-employment tax. Even though limited to the Medicare tax, the overall impact is a cost over 40% of the medical. Or, looked at in another fashion, that is a subsidy equal to over 40% of the cost if the business is a C corporation and pays the tax.

While there is a benefit for self-employed health insurance available for the non-C corporation owners that is supposed to offset the loss of the ability to provide health insurance to employees, there are additional limits to that benefit. First, it can only apply if the individual is not eligible to participate in the subsidized health plan of an employer of the individual or the individual's spouse.

Second, the deduction is also limited to the income that comes from the activity itself for the year—in a C corporation that insurance could give rise to a net operating loss that could be carried back to earlier years.

Third, under Notice 2008-1 there are strict reporting rules in place for S corporation shareholders that can mean failing to properly report the insurance on the Form W-2 (such as letting it flow out on the K-1 as a nondeductible item) may cause the loss of the deduction. While that latter problem can be corrected if caught by amending payroll reports and W-2s, that will be a lot of work that would not be necessary in the C context.

The plan does need to be specific in writing about who it covers and which expenses are paid for, and the anti-discrimination rules found in §105(h)(3). Note, though, that certain classes of employees can be excluded. Those classes, found in §105(h)(3)(B), include:

- Employees who have not completed three years of service
- Employees who have not attained age 25
- Part time employees – Under Reg. §1.105-11(c)(2)(iii)(C) that automatically excludes employees whose customary weekly employment is less than 25 hours. The number of hours can be as high as 35 if the employer can show either that other employees doing similar work for the employer have substantially more than 35 hours or, if no other employees do similar work, other employees in the same area and industry of the employer who do similar work work substantially more hours.
- Seasonal employees – Under the same regulation cited above for the part time employees, we can ignore employees whose customary annual employment is less than 7 months. As above, that number of months can go up to 9 months if comparable employees who work longer doing the same job can be shown to exist.
- Employees covered by a collective bargaining agreement
- Nonresident aliens with no earned income from sources within the United States.

Unincorporated individuals other than S corporation shareholders may be able to get around the problem if an individual's spouse is a legitimate employee of the enterprise. Revenue Ruling 71-588 provides specifically that a taxpayer whose spouse is a legitimate employee may sponsor a plan that provides medical benefits to the spouse-employee that includes coverage for the spouse-employee's spouse—which is the owner him/herself. The ruling remains in force today.

However this ruling is not carte blanche to simply sign a piece of paper and claim a tax deduction. As a number of taxpayers have discovered, there are a number of traps. When it appears nothing has changed from what was taking place before and the spouse is paid only a token salary aside from the medical reimbursement, the IRS has succeeded in overturning the plan (*Shellito v. Commissioner*, TC Memo 2010-41). Similarly, funds must be shown to originate from the business which reimburses the spouse, not merely paid by the married couple (see *Snorek v. Commissioner*, TC Memo 2007-34 and *Stephens v. Commissioner*, TC Summary 2008-18).

However it is possible to do things right—for example, see the case of *Speltz v. Commissioner*, TC Summary 2006-25 where the taxpayer's maintenance of records related to the spouse's work and faithfulness in following the terms of the plan preserved the deduction.

Note, though, that none of this will work for S corporation shareholders. There the problem that arises is §1372(b) which expands to definition of a “2 percent shareholder” to include those deemed to hold the shares under the attribution rules of §318. Thus, a taxpayer’s spouse is deemed to hold the same shares as the taxpayer.

In 2011 unincorporated businesses and S corporation shareholder will also miss out on a new benefit found in the Patient Protection and Affordable Care Act—the SIMPLE Cafeteria Plan.

For years beginning after December 31, 2010 a new cafeteria plan option is being made available to qualified small employers. The simple cafeteria plan, found at §125(j), is meant to allow small employers to avoid various otherwise applicable discrimination rules by meeting certain minimum contribution requirements to the plan, similar to the contributions made to safe harbor §401(k) plans to avoid certain discrimination testing otherwise applicable to those plans.

The discrimination tests deemed satisfied in a simple cafeteria plan include:

1. Discrimination in favor of highly compensated participants with regard to either eligibility for benefits or contributions to benefits in the cafeteria plan under §125(b)(1)
2. The 25% of cafeteria plan benefits to key employees test found in §125(b)(2)
3. §79(d) discrimination rules related to group term life insurance
4. §105(h) discrimination requirements related to health care reimbursements in favor of the highly compensated
5. §129(d) paragraphs (2) (general discrimination in favor the highly compensated), (3) (eligibility requirements in favor of the highly compensated), (4) (25% of benefits to principal shareholders, owners or related individuals) or (8) (55% of benefits to nonhighly compensated employees) related to dependent care programs [§125(j)(6)].

These provisions generally have served to make it difficult for owners of small, closely held businesses to benefit from cafeteria plans (aside from premium only plans), leading to few adoptions of such plans in such closely held entities.

To be eligible to establish a simple cafeteria plan, an employer must have employed, on average, less than 100 employees on business days during one of the two preceding years, though an employer must be in existence throughout a year for the year to be counted [§125(j)(5)(A)]. If the employer was not in existence throughout the preceding year, the employer can still qualify if it is reasonably expected the employer will employ less than 100 employees on average for business days during the year [§125(j)(5)(B)].

One an employer has qualified under the above test and established a simple cafeteria plan, it will continue to be treated as a qualified employer for that plan in any subsequent year until the number of employees exceed, on average, 200 or more in a particular year. In the year following attaining the 200 employee plateau, the employer will no longer be qualified to use the simple cafeteria plan deemed satisfaction of the above discrimination rules [§125(j)(5)(C)(ii)].

For purposes of the qualification test, predecessor employers must be considered, and any employer treated as related under §52(a) or (b) or §414(n) or (o) must be aggregated [§125(j)(5)(D)].

A simple cafeteria plan must meet one of two contribution requirements. The employer must either make an across the board nondiscretionary contribution of not less than 2% of compensation to the accounts of all eligible employees or it must make a matching contribution that is not less than the lesser of 6% of an employee's compensation for the year [§125(j)(3)(i)] or twice the employee's salary reduction contributions for the year [§125(j)(3)(ii)]--essentially, for an employer choosing the matching contribution option the employer must match twice the employee's level of contributions up to 3%.

If an employer chooses the matching option, it can make contributions beyond that minimum, but it is not allowed to have the rate of contribution for highly compensated employees be higher than the rate of contribution for the nonhighly compensated employees [§125(j)(4)]. This effectively prohibits having increasing contributions as the rate of contribution.

The choice between the two methods would generally depend on how much participation is expected by the rank and file employees, as well as the increased administrative complexity of computing matching contributions and the offsetting issue that all employees will need to dealt with administratively in the plan with an across the board contribution. Generally if few rank and file employees are expected to participate, the matching contribution method would be less expensive, while if on average the employees would defer more than 1% of compensation the flat 2% contribution would prove less costly.

The simple cafeteria plan must allow all employees that had at least 1,000 hours of service in the prior plan year to participate [§125(j)(4)(A)(i)] and must allow participating employees to select, subject to conditions applicable to all participants, any benefit available under the plan [§125(j)(4)(A)(ii)]. However, the plan is allowed to exclude employees who 1) have not attained age 21 before the close of the year, 2) have less than 1 year of service as of any day of the plan year, 3) who are covered under a bona fide collective bargaining agreement or 4) who are nonresident aliens described in §410(b)(3)(C). The rules allow the plan to set a younger age than age 21 for exclusion, or a waiting period of less than one year [§125(j)(4)(B)].

An analysis of this plan has to compare the expected required employer contribution cost against the expected additional benefits that will be available to highly compensated and key employees, as well as the simpler administration that comes from not needing to compute various discrimination testing formulas.

The eventual reduction of the maximum deferral to a medical flexible spending account to $2,500 effective beginning in 2013 blunts the benefit of this provision quite a bit, but in cases where there may be owners or relatives of owners that could benefit from having access to a dependent care plan this could open up an opportunity—but, again, the individual must be an employee making this more difficult to implement for unincorpated entities than for C corporations, and impossible to take advantage of for the most part in an S corporation context.

Personal Service Corporation Issue

One area that raises the concerns of many practitioners is the problem of the personal service corporation rules—but those rules may not have as broad a reach as sometimes is assumed.

An interesting case to look at is that of *Ron Lykins, Inc. v. Commissioner*, TC Memorandum 2006-35. That case involved a CPA firm that also had an investment advisory portion of the practice. Mr. Lykins split the firm into two pieces, an accounting firm and an investment advisory service on the advice of his attorney. The question became whether the accounting firm (Ron Lykins, Inc.) was a personal service corporation.

All employees stayed on the payroll of Ron Lykins, Inc, however they did work for the financial company as well with the entity billing the financial firm for the work. Those employees were doing about 19% of their work in the financial entity.

The regulations provide that an entity is a personal service corporation if it primarily provides services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and “95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field.”

The IRS argued that any services the employees of Lykins, Inc. performed related to the investment business was not properly counted as time spent by the employees serving in their capacity as employees of the accounting firm. The Tax Court disagreed, applying common law principles to determine that these individuals were employees of the accounting firm, not employees of both entities, as the employees were controlled by the accounting firm.

The key issue to remember is that if the entity does anything outside of the qualifying field, it’s likely the 95% test will not be met.

But it’s also important to note that the definition of personal services is not limited to “licensed professional services” as many seem to assume. This past year in the case of *Kraatz & Craig Surveying, Inc. v. Commissioner*, 134 TC No. 9 the Tax Court found that a firm that performed land surveying was performing services in the field of engineering, even though land surveying was not treated as engineering under state law.

Note that if a C corporation is found to be a personal service corporation, there’s no access to the lower tax brackets for the corporation and it faces required fiscal year rules. However if the entity has primarily a single individual performing services, it’s likely that any salary would be deemed to be reasonable (the only person generating the income is the service provider), so planning would generally involve insuring that the corporation does not have income and would serve to eliminate the corporate tax problem.

C CORPORATION RECENT DEVELOPMENTS

SECTION: 11
LAND SURVEYING PROPERLY DEFINED AS ENGINEERING IN REGULATIONS FOR PURPOSE OF PERSONAL SERVICE CORPORATION RULES

Citation: Kraatz & Craig Surveying, Inc. v. Commissioner, 134 TC No. 9, 4/13/10

The Tax Court had, in the case of Rainbow Tax Serv. vs. Commissioner, 128 TC 42, had ruled that the definition of accounting for purposes of determining if a C corporation is a personal service corporation, the field was not limited to those licensed as accountants under state law. Rather, the court held that we had to test that field based on its normal meaning.

Now the Tax Court turns to another of the defined fields for personal service corporations, engineering. In the current case, the taxpayer argued that land surveying should not be treated as engineering because state law did not treat land surveying as engineering, required separate licensing, and the firm had no licensed engineers on its staff. However, the Tax Court held that the IRS had included surveying in the definition of engineering in Temporary Reg. §1.448-T(e)(4)(i), and that the definition conformed to both the legislative record of what Congress saw as engineering and general dictionary definitions of engineering.

The Tax Court specifically held yet again that state licensing laws do not determine whether an activity falls into one of the affected categories, noting that due to lack of consistency among the laws making use of those laws would end up with taxpayers performing identical services being taxed differently.

Thus, the land surveying firm was subject to the flat 35 percent tax rate on its taxable income.

SECTION: 108
C CORPORATION TREATMENT OF §108(I) ACCELERATION RULE ADDRESSED IN TEMPORARY AND FINAL REGULATIONS

Citation: TD 9497, 8/11/10

The IRS issued temporary and proposed regulations that impact C corporations that have deferred recognition of cancellation of indebtedness income under §108(i). These regulations deal largely with the provisions of the acceleration of inclusion of the deferred gain under the provisions of §108(i)(5)(D). Generally that section provided that gain would be accelerated on certain events which include "the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances..." per the statute.

The IRS held that while technically appearing to be a triggering event, it would be contrary to the stated goal of §108(i) for the acceleration provisions to apply to transactions where §381(a) applies to allow the acquiring corporation to succeed to the tax attributes of the acquired corporation, specifically in the liquidation of a subsidiary under §332 or a transfer in an A, C, D, F or G reorganizations where §361 applies. Thus the regulations hold that such transactions will not be triggering events to accelerate the recognition of income.

Rather under the temporary and proposed regulations a C corporation will trigger acceleration if certain events that threaten ultimate collection of the tax take place. Those events are 1) a change in the entity's tax status, 2) the cessation of existence of the corporation in a transaction to which §381(a) does not apply or 3) engages in a transaction that reduces the net value of the corporation to such an extent that the ultimate collection of the tax is threatened. The regulations provide a net value acceleration rule test that, if violated, will trigger the recognition in the third circumstance.

Generally the net value acceleration rule is triggered generally if a corporation enters into an "impairment transaction" and the corporation at that points fails a mechanical net value test. An impairment transaction is any transaction that impairs the corporation's ability to pay the amount of the Federal income tax liability on the deferred COD income. Specifically such transactions would include distributions (including §381(a) transactions), redemptions, below market sales, donations and incurrence of additional indebtedness without a corresponding increase in asset value. Excluded from the treatment are value for value exchanges, including ones to which §351 (tax free incorporation) or §721 (tax free contributions to partnerships) apply.

If an impairment transaction takes place, the net value acceleration rule is triggered if the gross value of the corporation's assets is less than 110% of the sum of the the corporation's total liabilities and the tax on the net amount of the tax that would be due on the deferred items under §108(i). The tax due is computed by using the tax that would due at the highest applicable rate for the taxable year on the outstanding deferral, even if the corporation's actual tax rate is not that rate.

If the acceleration provision is triggered, then the entire remaining deferral is subject to tax at the time of the impairment transaction. However a corporation can escape this treatment if if value value is restored to the corporation by the due date of the corporate return, including extensions. The corporation must restore the lesser of the value of amounts that were removed in one or more impairment transactions (net of any amounts previously restored under this option) or the amount of the shortfall under 110% rule.

Special rules are provided that allow a member of a consolidated group to, at any time, trigger all of its remaining deferred COD income.

The regulations also provide that earnings and profits are not increased for the deferred amount of income until such time as the item is brought into income for the corporation.

Generally the rules apply to acceleration events occurring on on or after August 11, 2010. Given that the rules appear to be more generous than the literal reading of the law would allow, the regulations allow a corporation to elect to treat acceleration events occurring before August 11, 2010 under these rules and, if necessary, to restore value by the fifteenth day of ninth month following August 11, 2010.

SECTION: 162
PAYMENTS TO INVESTORS TO NOT REDEEM SHARES WERE DEDUCTIBLE UNTIL CLEAR AGREEMENTS WERE REASONABLY EXPECTED TO BE RENEWED AT TERMINATION

Citation: Media Space, Inc. v. Commissioner, 135 TC No. 21, 10/18/10

Payments made by a corporation to investors to not exercise their right to force the corporation to redeem their shares were held to be deductible in part by the Tax Court. In the case in question the corporation was obligated to redeem certain shares at specified dates at the shareholder’s request, something it lacked the liquidity to do as the dates approached. To prevent the shareholders from exercising those rights, the corporation offered to make a payment to the shareholders in exchange for their agreement not to exercise those rights for one year.

At the end of that year the company's position had improved, but it did not have the funds right away to redeem the shares. As such, it negotiated an 8 month extension of the agreement and paid an additional sum. When that 8 month term expired the company determined that it not only did not have the liquidity to make the payment, but was unlikely to have such ability in the foreseeable future. At point additional agreements were entered into.

The Tax Court agreed with the IRS that the corporation's initial treatment of the payments as interest deductible under §163 was incorrect, holding that no liability existed until a redemption was actually requested—something the payments prevented from happening. But the Tax Court for a time agreed with the taxpayer's alternative view that the payments were deductible as ordinary trade or business expenses under §162(a).

The Tax Court found evidence was submitted that making such payments to delay a redemption was normal operating practice in the industry, making it an ordinary and necessary expense. The Court did not agree with the IRS's view that the payments represented a payment in connection with the reacquisition of its stock blocked by §162(k) since, again, no such redemption occurred. The Court also rejected the IRS's alternative view that the payment was related to a reorganization under §368, with a deduction blocked by §361(c)(1).

The Court found that while Reg. §1.263(a)-4(d)(2)(i) would generally require the payments to be capitalized, the special 12 month exception found at Reg. §1.263(a)-4(f)(1) allowed a deduction for the payment for the first period as well as the first 8 month extension. In both cases, the corporation had an expectation of being able to redeem the shares at the end of that period.

However the Court found no such reasonable expectation existed after that date, with Reg. § 1.263(a)-4(f)(5)(i) requiring the expected duration of a right include the amount of any expected renewal period. By the time the second extension was made, experience suggested clearly that it was not reasonable to assume that another extension would not be the result at the end of the latest period, requiring that the payments be capitalized.

SECTION: 162
OWNER'S COMPENSATION FOUND REASONABLE IN PROFITABLE YEAR, BUT UNREASONABLY HIGH IN LOSS YEAR

Citation: Multi-Pak Corporation v. Commissioner, TC Memo 2010-139, 6/22/10

The Tax Court decided that the sole shareholder of a corporation had been paid a reasonable salary in the profitable year under question, but that his salary for the following year when performance suffered was unreasonably high and reduced that salary to a level that produced a 10% return on equity.

The case involved a company involved in a packaging business. The owner of the company had taken over the company from his father in 1972 when the company was near bankruptcy and over the years had made the company very successful. A major customer had increasing demands for packaging, and the sole shareholder was involved in the design and renovation of a new warehouse facility in the first half of the first year under consideration. In that year hit its all time high in revenue and paid the owner a total salary and bonus of $2,020,000. Net income after the payment of that compensation was $140,700.

The following year sales were not as good, but the shareholder received $2,058,000 in salary and bonus. For that year the company sustained a net loss of $474,000 after deducting the compensation to the owner.

The owner was paid a low base salary and monthly bonuses based on the company's results for the month. Bonuses were paid to the owner and his sons based on sales and the owner's judgment regarding results of operations and relative contributions of each.

The Tax Court rejected the testimony of both experts that testified on the reasonableness of compensation. The Court found that the taxpayer's expert failed to come to a conclusion about the reasonability of the rate of return to a theoretical independent investor, a key factor in the view of the Ninth Circuit to whom an appeal of this case would be taken. The IRS's expert did make a conclusion on the rate of return, but the Court found this expert had not used reasonably comparable entities to compare the results to, and had failed to adjust for those differences.

Ultimately the Court found an investor would have been satisfied with return in the profitable year, allowing the owner additional compensation due to the increase in sales and the fact that he was clearly responsible for the company's overall financial stability. But the Court found an investor would not have been satisified with a higher level of compensation in the following year when sales dropped and the payment of the compensation produced a return on equity in the negative of over 15%. Rather, the Court reasoned, an independent investor would have demanded reduced compensation.

The Court determined that the investor would be satisified with a 10% return, and reduced the salary deduction to $1,284,104 for the second year. The Court also found that even though the resulting deficiency for that year was high enough to trigger the substantial understatement penalty of §6662, the taxpayer had reasonably relied on the advice of its outside accountant as to the reasonability of compensation paid. The corporation regularly consulted with the accounting firm on this matter, and the firm advised the company on the reasonability of the salary paid.

SECTION: 304
IRS FINALIZES RULES ALLOWED IT TO IGNORE CORPORATIONS FORMED TO AVOID APPLICATION OF §304

Citation: TD 9477, 12/29/09

Final regulation §1.304-4 modified what had been a discretionary look through rule in Reg. §1.304-4T when the formation of a corporation avoided the application of §304 to a transaction. Generally, IRC §304 generally applies to transactions that attempt to effect what would otherwise be treated as a redemption (or attempted redemption) into a transfer of assets for the stock of the corporation. In such transactions, a portion of the property received is treated as a dividend to the extent of the earnings and profits of the two corporations.

Temporary Regulation §1.304-4T had been issued to address transactions where a new corporation or corporations were formed to avoid the application of this section. The IRS gives an example where Corporation A owns two foreign corporations that it labels F1 and F2. The basis and fair market value of F1 is $100,000, it has at least $100,000 worth of cash but has no earnings and profits. The basis and fair market value of F2 is $100,000 and it has more than that amount of earnings and profits. Corporation A forms a new foreign corporation F3 and contributes F2's stock to that corporation in exchange for F3 stock. Corporation A then transfers F3 stock to F1 in exchange for $100,000 of cash. Since neither F1 nor F3 has earnings and profits, Corporation A reported the transaction as a return of basis.

The temporary regulations allowed the IRS to unwind this transaction at the District Director's discretion, treating it as an acquisition by F2 (and getting access to F2's earnings and profits). The final regulations removes the discretionary standard and instead has the rule apply if a principal purpose for creating, organizing, or funding the acquiring or issuing corporation was to avoid the application of §304. The new regulations are effective on December 29, 2009

SECTION: 316
AUTO TITLED IN SHAREHOLDER NAME TREATED AS CORPORATE ASSET, AND DATE OF CHECK DETERMINED BY DATE ON CHECK NOT DATE DEPOSITED BY SHAREHOLDER

Citation: Rosser v. Commissioner, TC Memo 2010-6, 1/6/10

In general the taxpayers in Rosser v. Commissioner and Rosser Enterprises, Inc. v. Commissioner, TC Memo 2010-6 failed to gain deductions for which they had not provided supported, and were charged with a number of constructive dividends. But the IRS failed on two issues that may be of interest to practitioners.

The IRS failed in its claim that payments the corporation made on a loan for the purchase of a Ford van were constructive dividends. The van was titled in the name of the individual, and the loan was also in the individual shareholder's name. Nevertheless, the Tax Court found that the actual use of the van was for the business of the corporation. The Court held that the loan was in the shareholder's name for financing purposes, and the shareholder held the van as a nominee for the corporation.

The IRS also attempted to assess the shareholder a constructive dividend for 2004 on a check that was dated December 31, 2003 for $20,200, but which was deposited in the shareholder's bank account on January 6, 2004. The IRS claimed that the deposit six days into 2004 indicated that the taxpayer had backdated the checks and therefore it was available for assessment in 2004. However, the Court did not agree—it held that the date on the checks, in the absence of any evidence that the checks had been backdated, controlled in this case.

SECTION: 351
TAXPAYERS DID NOT TRANSFER FARMING ACTIVITY TO NEW CORPORATION, INCOME TAXABLE TO SHAREHOLDERS DIRECTLY

Citation: Slota v. Commissioner, TC Summary Opinion 2010-152, 10/12/10

Taxpayers at times aren't the best at following all the formalities when establishing a corporation or transferring their business to the corporation. In this case the taxpayer's inability to show that the underlying assets were transferred to the corporation resulted in the court finding that the deposit of proceeds from the taxpayer's crop in the corporate checking account was an impermissible assignment of income to the corporation.

The taxpayer owned and operated a farm as a sole proprietor. In 2005 he organized a corporation under Iowa law. However they executed no documents transferring title of any assets, including the farm land or crops, to the corporation, transferring only $10,000 of cash from their checking account. However when the money came in from the USDA for $61,416 or $195,938 for the crops, the amounts were deposited in the corporation and reported there.

The Court found that merely depositing the cash wasn't enough to treat the income as corporate income—rather, the amounts were truly taxable to the individuals.

SECTION: 565
IRS ALLOWS CORPORATION TO MAKE LATE CONSENT DIVIDEND ELECTION FOR PHC WHEN FINALLY ADVISED OF THE OPTION TWO YEARS LATER

Citation: PLR 201035002, 9/3/10

While, in general, ignorance of the law is not an excuse, in some cases it may get sympathy from the IRS Chief Counsel's office to allow for a late election. In the case in question the Company's president was a CPA, but apparently one not well versed in corporate taxation. He was the son-in-law of the couple that owned the corporation, and apparently was relied upon for tax decisions. One of his decisions was not to make a Subchapter S election when the corporation was formed. The CPA felt there was no need to do this, as the return would be simple as the only income of the corporation was interest income.

Of course, having only investment generated interest income meant that the corporation was subject to the personal holding company tax, something the CPA discovered when he prepared the return with unspecified tax preparation software. Being unaware of the option to have the couple take a consent dividend under §565, the CPA simply had the corporation pay the personal holding company tax. He then elected S status for the second year of the corporation's existence.

In late October of the third year, the President met with outside tax advisors to plan for year 3. The outside advisors informed him of the existence of the option to have taken a consent dividend back in the first year.

While not stated in the ruling request, it seems likely a problem the advisors noticed was that the corporation would have accumulated earnings and profits from that first year, thus triggering the application of the §1374 excess passive income tax and, more ominously, the potential loss of the S status under §1362(d)(3) after the third successive year of excess passive income. The imposition of that tax can be avoided if the accumulated earnings and profits are distributed to the shareholders, but if that was done in this case the taxpayers would now be paying tax on a dividend on top of the PHC tax paid for Year 1. An election under §565 would have avoided that double tax issue.

The IRS granted the corporation's request to make a late election for the shareholders to take a consent dividend for year one, finding that the taxpayers had acted reasonably and with good faith and granting the election would not prejudice the interests of the government.

SECTION: 6621
CONSOLIDATED GROUP NOT ELIGIBLE FOR INTEREST NETTING WITH OVERPAYMENTS FROM SUBSIDIARIES ACQUIRED AFTER YEAR OF UNDERPAYMENT

Citation: East Energy Corporation v. United States, United States Court of Federal Claims, No. 1:07-cv-00812, 3/12/10

IRC §6621(d) allows for “netting” for purposes of computing interest due on tax assessements any overpayments and underpayments by the same taxpayer. In a case of first impression for this court, the Court of Federal Claims had to decide if a parent corporation and subsidiaries acquired after the date the tax underpayment by the parent took place should be considered the “same taxpayer” for these purposes.

The Court of Federal Claims decided that to be the “same” taxpayer, it was crucial that the taxpayer be “identical” and “without addition, change or discontinuance,” basing its view on the “plain meaning” of the term. The court consulted Webster's Ninth Collegiate Dictionary specifically to arrive at the “plain meaning” of the word “same” and noted that, in fact, the new consolidated group failed to be the “same” taxpayer under that definition. Thus the overpayments and underpayments could not be netted for purposes of computing the interest due from the now consolidated group.

SECTION: 7701
LATE REQUEST FOR AUTOMATIC RELIEF UNDER REV. PROC. 2009-41 SHOULD RESULT IN CHANGE EFFECTIVE EXACTLY 3 YEARS AND 75 DAYS PRIOR TO DATE OF REQUEST

Citation: Chief Counsel Email 201036019, 9/10/10

In emailed advice the Chief Counsel’s office considered an issue arising under Revenue Procedure 2009-41, the ruling that liberalized the relief for late entity choice elections under the check the box regulations, giving automatic relief in some cases. The question discussed in this letter is what should the IRS Service Center do if a taxpayer files for such relief, but the request is filed more than 3 years and 75 days after the requested effective date.

Revenue Procedure 2009-41 requires that the taxpayer must request relief within 3 years and 75 days after the date when the election had originally been intended to be effective and show reasonable cause for the late filing.

Interestingly enough, the email suggests the proper course is for the IRS to initially grant the request effect as of the date 3 years and 75 days before the filing date of the request. That is interesting because, in fact, the taxpayer is not claiming an intent to have made that arbitrary date as the date for which a change of entity was to be effective.

The email notes that the Service Center should suggest to the taxpayer that it could apply for a private letter ruling granting relief back to the originally requested date. Note that such a ruling would have to go through the formal ruling request procedure including the payment of the required fee.

SECTION: 7701
IRS LIBERALIZES RELIEF FOR LATE ENTITY ELECTIONS UNDER CHECK THE BOX RULES

Citation: Revenue Procedure 2009-41, 9/3/09

The IRS liberalized the rules for automatic late election relief for entity classification elections. For an entity that failed to timely file an election to make or change its entity classification, it can qualify for automatic relief if all returns have filed consistent with the classification chosen (if any returns have yet been due), the only reason the entity does not have its intended classification is due to the late filing of Form 8832, the entity has reasonable cause for the late filing and the request is filed within 3 years and 75 days of the date the entity intended to have its different classification.

An election under this procedure must be filed on a Form 8832 that includes a declaration that all requirements of the procedure have been met and, until Form 8832 is modified, must have “Filed Pursuant to Rev. Proc. 2009-39” written at the top of the Form 8832. The 8832, the declaration and the reasonable cause statement must be filed with the applicable IRS service center.