June 2018 Supplement
George K. Yin & Karen C. Burke, Corporate Taxation (2d ed. 2016)

This supplement mainly reflects changes enacted by Pub. L. No. 115-97, 131 Stat. 2054 (2017), in late 2017.

1. <u>Page 1: substitute new chapter one</u>:

Chapter 1: Introduction to Corporate Tax

A. Introduction

From prior study, you are already familiar with the basic concepts of income taxation, including what income is, when it arises, and what its character is. No doubt, you have also been exposed to the fictional legal entity known as a "corporation" and some of the rules and policies pertaining to it. This course explores what happens when income is earned by a business that is organized in corporate form or treated as one for tax purposes.

Let us begin with an example. Assume that your daughter, Laura, decides to invest $10 of her savings to operate a lemonade stand. She uses the $10 to purchase the items necessary to get the business started—the stand, cups, lemons, and so forth. She then proceeds to hawk her drinks out by the curb in front of your house. The day is hot, the drinks are cool, your daughter is cute and efficient, and your neighbors are kind, and she therefore successfully sells a number of drinks by day's end.

If necessary, we might calculate her income for the day using familiar principles. First, she should have income from services, that is, her compensation for sitting out all day in the hot sun peddling her drinks. Further, as the owner of the enterprise, she may have business income equal to her total receipts less properly allowable expenses (including the compensation her business pays to her). The business income might be thought of as the return she obtains from investing her $10 for one day in the manner described. Our principal concern in this course will be with the taxation of the business income, the income from her $10 capital investment.

Should the tax treatment of the business income vary, depending upon the *form of organization* of the business? For example, the foregoing describes how the business profits might be taxed if the lemonade stand is operated as a *sole proprietorship*. But suppose your daughter has only $5 in her piggy bank and therefore seeks out her older sister, Elizabeth, for the remaining capital needed to start up the business. Elizabeth provides the additional $5 but only on condition that the two sisters form a partnership and share equally in any profits from the business. How should the profits of the *L&E partnership* be taxed?

At least in theory, it is difficult to see why the profits of the partnership should be taxed any differently from those of the sole proprietorship. There is simply more than one owner now. But the economic activity undertaken in the two situations is exactly the same. Moreover, taxing the two situations differently would have the effect of either encouraging or discouraging the pooling of capital.

In fact, partnerships (as well as entities such as limited liability companies (LLCs) that may be treated as partnerships for tax purposes) *are* taxed essentially along the lines of the sole proprietorship model. This method of taxation is variously referred to as "passthrough," "flowthrough," "conduit," or "aggregate" taxation. The legal entity (the partnership in this case) is generally ignored for purposes of paying tax. Instead, it is treated as a "conduit" and the income tax items relating to the business are passed through to the owners of the enterprise—the partners—who are the real (and only) taxpayers in interest. Under this approach, the partnership is conceived of as an "aggregate" of owners, each of whom is taxed as if she owned an individual interest in the partnership's assets and conducted the partnership's business directly.

Suppose the two sisters decide to incorporate their business, perhaps out of concern about the potential liabilities arising from it or for other good business reasons. The sisters agree to take back equal shares in the corporation. How should the profits of *L&E, Inc*. be taxed?

Again, at least in theory, perhaps the same partnership/sole proprietorship model should be followed. The underlying economic activity of the business seems to be the same, no matter what the form of organization. Therefore, why not tax the results of the underlying economic activity in the same way, regardless of the form of organization? Why not simply treat the legal entity (the corporation, here) as a mere conduit for tax purposes and have it pass through all tax items to the shareholders, the real taxpayers in interest?

Under current law, just over 70 percent of all corporations (referred to as "S corporations" because they are governed by subchapter S of the Code (I.R.C. §§ 1361-1379)) *are* treated as conduits for tax purposes. Like partnerships, their taxable income and other tax items are passed through to their owners (their shareholders) who must report and pay tax on such amounts. But although each is treated as a "passthrough entity" for income tax purposes, sole proprietorships, partnerships, and S corporations are not taxed exactly alike. Moreover, not all corporations qualify for S corporation treatment or choose to be taxed in that manner. The law does not provide passthrough treatment for most other corporations (including essentially all public corporations), sometimes termed "C corporations" because they are principally governed by the rules of subchapter C of the Code (I.R.C. §§ 301-385). Indeed, unlike S corporations, C corporations are respected as taxable entities separate and distinct from their shareholders. Business profits earned by a C corporation, therefore, may be taxed twice: the corporation may pay tax on them and the shareholders may pay another tax when they receive the earnings. As we shall see, however, many businesses organized as C corporations are able to avoid that result to a large extent and to achieve the equivalent of a passthrough result.

In summary, when she starts her business, Laura (maybe together with her sister) must decide on its organizational structure—commonly referred to as the "choice of entity" question. The basic choice is between using a C corporation or a passthrough form with several possibilities available for the latter category. Tax considerations have always played a role in the decision, but the tax stakes were significantly modified and enhanced by legislation passed at the end of 2017. For that reason, we describe in part B the major features of the new law affecting choice of entity. Many details are omitted, many questions remain unresolved, and full appreciation of the importance of the changes will require study of the rest of this book (as well as a separate course in partnership tax). But we believe the key changes are important enough to introduce them right at the beginning of your study. A complicating factor—largely ignored in the following description—is that most of the individual income tax changes presently expire at the end of 2025 whereas most of the corporate income tax changes do not. We also generally limit the discussion to considering the impact on U.S. businesses that lack any cross-border income.

B. Major Tax Changes Affecting Choice of Entity After 2017

1. Tax rate changes

Immediately prior to 2018, the income of individuals and C corporations was taxed at progressive rates up to a maximum of 39.6 and 35 percent, respectively. Both types of taxpayers were potentially liable for an alternative minimum tax (AMT) in addition to any income tax.

The 2017 legislation reduced both the individual and corporate tax rates, significantly decreased the scope of the individual AMT, and repealed the corporate AMT. Beginning in 2018, income (including capital gain) of a C corporation is taxed at a flat rate of 21 percent—a 40 percent decrease from the prior maximum rate. The legislation cut the income tax rates of individuals across the board, but by much less than the corporate rate reduction.[1] **Table 1-1** shows the 2018 income tax rates and tax liability (before credits) of a single person who is not a head of household and a married person filing a joint return. Except for the two highest brackets, the bracket widths for joint filers are exactly twice those for single individuals. The table shows the tax rates applicable to amounts of *taxable* income. Individuals are entitled to claim a standard deduction of $12,000 ($24,000 for joint filers) in 2018 (increased from $6,350 and $12,700, respectively, in 2017), effectively providing them with a zero tax bracket for those amounts before determining the rates and tax shown in the table. The range of the zero tax bracket is effectively enlarged for taxpayers entitled to claim credits, such as the child tax credit (increased from $1,000 to $2,000 per qualifying child in 2018) and the earned income tax

[1] Although the new law reduced tax rates across the board, it also modified bracket widths. The result was that, based only on the tax rate changes, the new law actually increased taxes on some higher-income individuals. For example, under 2017 rates, a single individual who was not a head of household paid a 33 percent tax on any taxable income over $200,000 but not over $416,700. The same individual in 2018 must pay tax of 35 percent on the same income. See **Table 1-1**. As a result, if the individual has exactly $416,700 in taxable income, the taxpayer will pay over $600 more in income tax in 2018 than in 2017.

credit.[2] The impact of the increases to the standard deduction and child credit was partly offset by repeal of the deduction for personal and dependent exemptions ($4,050 per exemption in 2017).

Table 1-1: 2018 Income Tax Rates and Tax Liability (Before Credits): Impact on Single and Married Individuals

Single individual who is not a head of household	Married individual who files a joint return	2018 income tax rate and tax liability (before credits)
amount of taxable income		
up to $9,525	up to $19,050	10% of amount in first bracket
over $9,525 up to $38,700	over $19,050 up to $77,400	plus 12% of excess over cut-off for first bracket
over $38,700 up to $82,500	over $77,400 up to $165,000	plus 22% of excess over cut-off for second bracket
over $82,500 up to $157,500	over $165,000 up to $315,000	plus 24% of excess over cut-off for third bracket
over $157,500 up to $200,000	over $315,000 up to $400,000	plus 32% of excess over cut-off for fourth bracket
over $200,000 up to $500,000	over $400,000 up to $600,000	plus 35% of excess over cut-off for fifth bracket
over $500,000	over $600,000	plus 37% of excess over cut-off for sixth bracket

The new law generally did not change the tax rates on an individual's qualified dividends or long-term capital gain. Such income is generally taxed at 0, 15, or 20 percent, with the top rate applicable to single individuals whose taxable income exceeds $425,800 ($479,000 for joint filers) in 2018. The new law also did not change the 3.8 percent tax on net investment income ("NII") (generally, passive-type income including capital gain) of individuals. The taxable NII base is limited to the amount by which the taxpayer's modified adjusted gross income exceeds $200,000 for single individuals ($250,000 for joint filers). By setting the corporate tax rate 16 percentage points below the maximum tax rate for individuals (21 percent versus 37 percent (not counting the NII tax)), the new law generally provides a stronger incentive to operate businesses through C corporations. But the ultimate choice will depend on many factors, including changes to the business tax base made by the new legislation, described in general terms below.

2. Section 199A deduction and other tax base changes affecting business entities differently

a. Section 199A deduction

[2] Importantly, taxpayers with much higher amounts of income will be eligible to claim the child credit in 2018. In 2017, the $1,000 credit was completely phased out for joint filers with modified adjusted gross income of $130,000 or more. In 2018, the $2,000 credit will not be completely phased out until joint filers have modified adjusted gross income of at least $440,000.

The new law added a very complicated (and not entirely coherent) tax deduction generally available only for individuals who earn business income through a passthrough entity, including a partnership, S corporation, or sole proprietorship. See I.R.C. § 199A. Thus, the deduction generally benefits owners of those entities who are individuals; neither a C corporation (including one that is an owner of a passthrough business) nor an individual who is a mere employee (and not an owner) of a passthrough business, is eligible. The deduction has the effect of a tax rate cut because an eligible taxpayer merely has to have the right type of income to claim it. The basic idea was to provide owners of passthrough businesses with a tax rate cut roughly comparable to that given to C corporations. Another motivating idea was to limit the tax benefit to the capital, and not labor, income of passthrough business owners, again to match roughly the effect of the C corporation tax rate cut. So someone like Laura, if she earns income from owning a lemonade stand (a business) through a sole proprietorship (a "passthrough entity" for this purpose) might be entitled to claim this deduction for a portion of her business income. At least in theory, the deduction should only reduce tax on her capital income from the business (i.e., the income from her $10 investment) and not her labor income (her compensation for hawking drinks near your house all day long).

Unfortunately, this general description is correct only in theory. For various reasons, including political concessions, practical difficulties, and perhaps just confusion or oversight, the new deduction and its limitations are applied very unevenly. Thus, the end result lacks theoretical consistency and only imperfectly achieves the purported goals. There also remain many unsettled questions concerning the precise parameters of the deduction and limitations.

In general, the section 199A deduction is equal to 20 percent of a taxpayer's "qualified business income."[3] As a result, a passthrough business owner who is entitled to the maximum deduction and is in the top tax bracket (37 percent) must generally pay tax on qualified business income at a top rate of 29.6 percent (80% of 37 percent). This tax rate is not as low as the C corporation rate, but remember that income earned through C corporations may be taxed again when received by a shareholder.[4] The section 199A deduction is generally limited to 50 percent of the owner's share of the passthrough business's W-2 wages. So owners of passthrough businesses with very few employees may receive less than a 20 percent deduction.[5] The section 199A deduction does not

[3] The deduction generally may not exceed the taxpayer's taxable income (excluding net capital gain) for the year. See I.R.C. § 199A(a), last sentence. The remaining discussion assumes that this limitation is not binding.

[4] The top 29.6 percent rate is also just the rate on a passthrough owner's qualified business income falling within the highest tax bracket for individuals. Some of the owner's qualified business income may be taxed at inframarginal rates below the flat corporate rate of 21 percent. The optimal strategy, if available, might be for a taxpayer to earn qualified business income through a passthrough entity up to the amount that would be taxed at less than 21 percent (after taking into account the section 199A deduction) and to earn any additional amounts through a C corporation.

[5] Alternatively, the section 199A deduction is limited to 25 percent of the owner's share of the business's W-2 wages plus 2.5 percent of the share of the business's unadjusted basis in certain depreciable property, if this limitation is greater than the "50 percent of wages" test. See I.R.C. § 199A(b)(2). Hence, owners of businesses with few employees (such as certain real estate businesses) may still qualify for the maximum deduction if the business owns enough qualifying depreciable property (such as buildings). The

reduce adjusted gross income but may be claimed even if the taxpayer does not itemize. See I.R.C. § 63(b)(3).

"Qualified business income" generally means the net income (other than investment-type income) from a U.S. trade or business. It generally excludes, however, income from businesses engaged in the performance of most professional services and certain investment activities. See I.R.C. § 199A(c)(1) and (3) and (d)(1) and (2).[6] The disqualification of most professional service income is consistent with the notion of limiting the tax benefit to capital and not labor income. Oddly, however, C corporations are entitled to the 21 percent tax rate even if they are engaged in the same service activities that are disqualifying for passthrough entities. These corporations, generally referred to as "personal service corporations," were formerly taxed at a flat 35 percent rate (without the benefit of the progressive corporate tax rates) to prevent them from being used as tax shelters by high-income professionals. Under the new law, however, the income of professional service businesses operated as C corporations is taxed at the flat 21 percent corporate rate, whereas the same income of a passthrough business may be taxed at the highest individual rate because it does not qualify for the section 199A deduction. Taxpayers generally must determine the availability and amount of the section 199A deduction separately for each passthrough business that they own.

Recall that the goal of generally limiting the tax benefit of section 199A to capital income should in theory require owners like Laura to exclude from their qualified business income any compensation that they earn from the business for performing services. Under the new law, however, Laura may be required to exclude her reasonable compensation from qualified business income only if she operates her business through an S corporation. If she organizes it as a sole proprietorship or partnership, the law is not entirely clear but Laura would not seem to be subject to the same limitation. See I.R.C. § 199A(c)(4). It is hard to fathom any justification for this discrepancy. Of course, as a practical matter, the different tax treatment may be largely academic. Determining the amount of reasonable compensation that an S corporation should have paid its shareholder for services (and hence the proper amount taken into account for purposes of the shareholder's employment taxes and now also excluded from her qualified business income) has proven to be very challenging for the IRS; in the future, the challenge may be even greater in light of the new, higher stakes involved. Complicating the IRS's task is that some taxpayers may benefit from *overstating*—rather than understating—the amount of reasonable compensation paid to a shareholder in order to increase the amount of the business's W-2 wages (and therefore potentially increase the section 199A deduction).[7]

---

policy reason for the wage and property limitation tests is not clear. C corporation businesses receive the benefit of the 21 percent tax rate without regard to their W-2 wages or investment in depreciable property.

[6] The income of businesses engaged in law, health, accounting, consulting, performing arts, and other professional services, or whose principal asset is the reputation or skill of one or more of its owners or employees, generally does not qualify for the deduction. See I.R.C. §§ 199A(d)(2), 1202(e)(3)(A). The income of engineering and architectural businesses may qualify, although the statute is somewhat ambiguous on that point.

[7] In general, an S corporation with no employees other than a sole shareholder and no qualifying depreciable property can maximize the potential section 199A deduction by paying its shareholder wages exactly equal to 2/7 (about 28.6%) of the qualified business income (determined before taking into account

Finally, bear in mind that if Laura is *only* an employee of the business (and not an owner), she is ineligible for the section 199A deduction, regardless of the organizational form of the business.

> **Example 1-1**: Laura performs services for a passthrough business for which the reasonable compensation is $100. If she is only an employee and not an owner of the business, she is fully taxed on the $100 of compensation income without the benefit of the section 199A deduction. If she is the sole owner of an S corporation, is allocated qualified business income of $500, and receives no separate compensation for services, then her section 199A deduction is limited to 20 percent of $400 (the qualified business income of $500 less her $100 reasonable compensation for services), or an $80 deduction. (This result assumes that the $100 reasonable compensation for services can be adequately established by the IRS.) If, instead, the business is organized as a partnership or sole proprietorship, she may be entitled to a section 199A deduction equal to 20 percent of $500, or a $100 deduction, since there does not appear to be any requirement to exclude reasonable compensation in those settings. (It is assumed that the W-2 wage limitation is not binding.)

Finally, the service-business and wage limitations are both inapplicable if the business owner is a single person with taxable income not in excess of $157,500 ($315,000 for a joint filer) in 2018 (determined without regard to the section 199A deduction).[8] Assume that Laura's taxable income does not exceed those thresholds. In that case, she would be entitled to the full section 199A deduction even if her passthrough business performed legal services (a disqualifying professional service business) or had no employees (and therefore paid no W-2 wages). A phase-in rule allows single persons with not more than $50,000 (or joint filers with not more than $100,000) of taxable income above the threshold amount to still obtain a partial deduction even if the service-business or wage limitations are violated. Importantly, the income from performing services as an employee does not qualify for the section 199A deduction, regardless of the taxpayer's taxable income. See I.R.C. § 199A(d)(1)(B). Except for the across-the-board tax rate reductions, the income earned by an employee generally receives no special benefit under the new law.

In summary, section 199A is a complicated and inconsistent provision whose interpretation may plague the tax law for years. It offers the prospect of substantial tax

---

any compensation). For example, assume that qualified business income before any compensation is $1,000. If the S corporation pays its shareholder $286 (28.6% of $1,000) in wages, the "50% of wages" cap (50% x $286, or $143) and 20 percent of qualified business income after taking into account the compensation (20% x $714 ($1,000 - $286), or also $143) are equal (both $143). Paying the shareholder more or less than $286 in wages will reduce one amount or the other; thus, the amount of the section 199A deduction (which is equal to the lesser of the two amounts) will be reduced. Whether this strategy is advantageous will depend upon the income tax effect of the potential section 199A deduction and the employment tax consequences to the shareholder. The same strategy will generally not be available to partnerships since partners are not considered employees of their partnerships and therefore any compensation paid to partners for services (including a guaranteed payment) would not be considered W-2 wages.

[8] These thresholds limit the special treatment to individuals who are below the 32 percent tax bracket. See **Table 1-1**.

savings for many taxpayers but at the cost of considerable uncertainty, increased compliance burdens, and exposure to litigation risk. Fairly or unfairly, the new law also increases the stakes of such risk: taxpayers claiming the section 199A deduction will be more susceptible to owing a 20 percent penalty on any tax underpayment, apparently even if the underpayment is not attributable to the section 199A deduction. See I.R.C. § 6662(d)(1)(C) (lowering the threshold for substantial understatement penalty if section 199A deduction is claimed).

b. Other tax base changes affecting business entities differently

Aside from the tax rate changes and section 199A deduction, two other principal changes affect businesses differently depending upon how they are organized. Both changes favor C corporations. One change concerns the deductibility of state or local taxes. C corporations are generally entitled to deduct as ordinary business expenses any state or local income, property, or sales taxes incurred in connection with their business operations. While again not entirely clear, it appears that a different result occurs if the same business incurring the same taxes is organized as a passthrough entity (including a sole proprietorship). In that case, the passthrough owner may deduct the business's property and sales taxes as business expenses. The owner, however, may deduct the business's state or local income taxes only as an itemized deduction, subject to a new $10,000 annual limit on the aggregate amount of all state or local taxes claimed as itemized deductions. Individuals may generally deduct state or local taxes as itemized deductions without regard to whether they are paid or incurred in a trade or business or a for-profit activity, but the total deduction is limited to $10,000 each year. See I.R.C. § 164(b)(6).

The other principal change involves the deductibility of business losses. In the case of individuals, closely held corporations, and personal service corporations, "passive loss" rules (under prior and current law) limit deductions and credits relating to certain passive business activities. In effect, these rules create in part a "schedular" tax system that precludes, for example, a taxpayer from offsetting compensation or investment income with losses from business activities in which the taxpayer does not materially participate. Under these rules, passive business losses may generally offset only passive business income, with any excess passive losses carried forward to be used against passive business income in future years. Prior to 2018, however, no general limitation applied to the deduction of business losses from activities in which the taxpayer materially participated.

The new law limits the deduction of a broader class of business losses, but only for individuals owning passthrough businesses. C corporations are not subject to the new loss-limitation rule. See I.R.C. § 461(*l*). Under the law, losses from a trade or business in excess of $250,000 ($500,000 for joint filers) in 2018 may not be deducted currently but must be carried forward for possible deduction in future years. The loss-limitation rule applies regardless of the taxpayer's level of participation in the business. The passive loss rules are retained and apply before the new limitation.

3. Examples

The following simplified examples illustrate some effects of the tax rate changes and section 199A deduction in the case of a single person (not a head of household) planning to start a new business. The owner expects the business to produce $50,000 in net profit in 2018 if it is organized as a C corporation or sole proprietorship (or the same amount of profit for the owner if the business is organized as a passthrough entity with more than one owner). In **examples 1-2** through **1-4**, the owner has over $500,000 of taxable income in 2018 (before any business income); thus, the owner is in the 37 percent income tax bracket and pays a 20 percent tax on dividends and long-term capital gain and a 3.8 percent tax on all NII. The owner is also fully subject to the service-business and wage limitations in section 199A. All examples ignore other differences from use of these business forms, including employment taxes, the individual AMT, and state and local taxes.

Example 1-2: Assume that the business is not disqualified and has $50,000 in net profit after all expenses including $30,000 of W-2 wages paid to employees other than the owner. As a C corporation, the $50,000 net profit will be taxed at 21 percent, giving rise to a tax liability of $10,500. If the remaining $39,500 in income after the corporate tax is immediately distributed or realized as a long-term capital gain, the shareholder will owe additional income and NII tax of $9,401 (23.8% x $39,500) for a combined tax of $19,901 ($10,500 + $9,401).[9]

If the business is organized as a passthrough and the amounts in **example 1-2** represent the owner's share of the business's profit and wages, the business owner is entitled to a section 199A deduction of $10,000 (20% x $50,000). One-half of the $30,000 in W-2 wages is $15,000 so the wage limitation is not binding. The owner will therefore owe income tax of $14,800 (37% x $40,000 or, equivalently, 29.6% x $50,000). If the owner does not materially participate in the business, the owner will also owe NII tax on the net profits of the business (unreduced by the section 199A deduction).[10] Thus, the owner will owe total tax of $16,700 (37% x $40,000 plus 3.8% x $50,000). In either situation, the passthrough result is worse than the C corporation result ($10,500), ignoring any shareholder-level tax. It is better, however, than the C corporation result ($19,901) if there is an immediate shareholder-level tax.

Example 1-3: Same as **example 1-2**, except that the business pays only $5,000 of W-2 wages to employees other than the owner. The C corporation result is the same as in **example 1-2**, since the wage amount is irrelevant. The passthrough owner's section 199A deduction, however, will be limited to $2,500 (50% x $5,000). The owner therefore will owe tax of $17,575 (37% x $47,500) or $19,475 (37% x $47,500 plus

[9] The combined tax rate is 39.8 percent (21% + (23.8% x 79%)). The combined rates are 36.8, 35.9, and 32.9 percent if the shareholder tax rate is 20 percent (without any NII tax), 15 percent (with the NII tax), and 15 percent (without any NII tax), respectively. All combined rates assume a shareholder-level tax at the same time as the corporate tax.

[10] The section 199A deduction is only allowed for purposes of chapter one of subtitle A of title 26 (i.e., I.R.C. §§ 1-1403) and therefore does not reduce the amount taxable under the NII tax imposed by section 1411 and does not affect self-employment taxes. See I.R.C. § 199A(f)(3).

3.8% x $50,000), depending upon the applicability of the NII tax. Although the passthrough result is worse than in **example 1-2**, the comparison to the C corporation result is unchanged.

Example 1-4: Same as **example 1-2**, except that the business is disqualified because it involves the performance of professional services. The result to a C corporation, even if it is a personal service corporation, is again the same as in **example 1-2**, unaffected by the change of fact. The passthrough owner, however, will lose any section 199A deduction and thus will owe tax of $18,500 (37% x $50,000) or $20,400 (40.8% x $50,000), depending upon the applicability of the NII tax. The NII tax would not apply if the owner is actively involved in the performance of the business's services. If the NII tax does apply, the result (tax of $20,400) is worse than the C corporation result even if there is an immediate shareholder-level tax (total tax of $19,901).

The following **examples 1-5** and **1-6** assume that the owner has $100,000 of taxable income in 2018 (before any business income), is in the 24 percent tax bracket, pays a 15 percent tax on dividends and long-term capital gain, and is exempt from the NII tax.

Example 1-5: Assume that the business is not disqualified and has $50,000 in net profit after all expenses including $5,000 of W-2 wages paid to employees other than the owner. As a C corporation, the $50,000 of net profit will be taxed at 21 percent, triggering a tax liability of $10,500. If the remaining $39,500 in income after the corporate tax is immediately distributed or realized as a long-term capital gain, the shareholder will owe an additional income tax of $5,925 (15% x $39,500) for a combined tax of $16,425 ($10,500 + $5,925).

If the business is organized as a passthrough and the owner's share of net profit is $50,000, the owner is entitled to a section 199A deduction of $10,000 (20% x $50,000). Because the owner's income (including the business income) is less than the $157,500 threshold, the wage limitation is not applicable. The owner will therefore owe income tax of $9,600 (24% x $40,000), or less than the C corporation tax of $10,500. The C corporation result would be even worse if there were an immediate shareholder-level tax on distributed earnings or long-term capital gain.

Example 1-6: Same as **example 1-5**, except that the business is disqualified because it involves the performance of professional services. For both the C corporation and the passthrough business, the result is the same as in **example 1-5**. Because the owner's income (including the business income) is less than the $157,500 threshold, the service-business limitation is inapplicable.

In broad terms, the examples illustrate that very high-income business owners may especially benefit from using C corporations for their business activities. One of the biggest winners under the new law may be very high-income professionals who are able to incorporate their professional services, thereby potentially reducing their tax rate dramatically below 37 percent if they are willing to accumulate earnings in the corporation or can withdraw earnings in a tax-favored way. Conversely, owners with more modest levels of income may prefer to use a passthrough structure. But much will depend upon the owner's specific situation and business plan. Start-up businesses that expect to incur losses in their early years will almost certainly benefit from initial use of a passthrough form because of the owners' ability to claim losses as they arise. Other details in the new law, including those not mentioned in this chapter, may also influence the choice-of-entity decision. Finally, factors described in succeeding chapters of this book—such as the specific taxation of the business operations and the tax consequences of forming, selling, and exiting one of the business entities—will also need to be considered. As we shall see, creating or entering a C corporation can generally be done without immediate tax consequences but departing from one generally cannot.

Importantly, taxpayers will not be limited to a binary choice of using either a passthrough structure or a C corporation. The many categories in the new law, as well as their significant and disparate effects, offer incentives for taxpayers to explore hybrid arrangements involving multiple entities owned by overlapping economic interests. For example, consider a law firm partnership that performs legal services and also owns the building the firm uses. All of the firm's partners have taxable incomes exceeding the high-income thresholds in section 199A but most of its associates do not. Without any further changes, the firm, its partners, and associates may all be ineligible for any of the tax benefits of the new law other than the modest across-the-board rate cuts for individuals. Yet, the result might be improved significantly if the owners: (1) formed different entities to separate ownership of the building from the performance of services, thereby permitting the firm's income from the building to qualify for the section 199A deduction;[11] (2) incorporated part of the law practice in a C corporation so that at least some of the income from legal services could be taxed at only 21 percent; or (3) changed the status of the associates from employees to owners of a passthrough entity to enable them to benefit from the section 199A deduction. Tax advisors will need to evaluate the full ramifications of these types of changes and the risk of challenge from the tax authorities.

* * * * *

With that somewhat lengthy introduction, we can now turn to the balance of the book. Chapter two focuses on the taxation of S corporations and their shareholders. As discussed, this chapter describes an intuitive way to tax business income in accordance with the sole proprietorship model. The 2017 tax legislation did not change the basic operating and eligibility rules of subchapter S, but these rules now need to be considered in light of the altered tax landscape for all business entities.

Chapter three explains what types of business entities are treated as corporations for tax purposes and therefore are taxed as C corporations if they have not elected (or are ineligible for) S status. The chapter provides more detail on how the business profits of C

[11] For example, the law firm partnership might transfer the building to its new, wholly-owned LLC. If this restructuring is respected for tax purposes, then rent paid by the firm to the new LLC for use of the building may give rise to income eligible for the section 199A deduction.

corporations are taxed and describes various ways in which the "double tax" may be reduced or avoided altogether. The chapter concludes with several proposals to reform the taxation of C corporations. The most important are proposals to "integrate" the corporation and shareholder income taxes so that corporate-source income is not taxed more than once. We consider why all corporations are not treated as conduits for tax purposes and whether there are other ways to achieve roughly the same outcome.

Beginning with chapter four and continuing through to the end of the book, we turn to the taxation of *transactions* between corporations and their shareholders and between one corporation and another. Consideration of these issues requires us to delve into some of the wonderful mysteries of subchapter C of the Internal Revenue Code. Although these rules remain largely unchanged by the new law, the implications of tax strategies involving these rules may well be affected. We examine these transactions carefully, moving from the simple to the complex, and identify the continuing themes in the taxation of corporate transactions that provide some coherence to this body of law. For example, the final chapter of the book, dealing with the taxation of tiers of C corporations that have been organized into "affiliated groups" filing a single, "consolidated return," requires us to revisit the passthrough tax principles first encountered in chapter two in order to ensure that the income of such groups is not excessively taxed.

As we shall see, the complexity of corporate transactions, their potential importance to the economy and the fisc, and the inventiveness of taxpayers and their advisors, have all contributed to the creation of a detailed and complicated set of laws specifying the tax consequences of the transactions. However sensible each of these laws may be if considered in isolation, their interaction with one another in the context of a particular transaction has almost inevitably led to some nonsensical results surely not contemplated by the drafters of the laws. Thus, an important issue frequently arising in tax law in general, and in corporate tax in particular, is how literally the law should be interpreted and applied. We focus on that topic specifically in chapter four but consider it throughout the book.

Let us not get too far ahead of ourselves, however. For now, let's return to our incorporated lemonade stand. What types of conceptual problems are raised if the legal entity is ignored for tax purposes? How might those problems be addressed?

2. **<u>Page 26: add to note</u>**:

In addition to minimizing employment taxes, S corporations that understate the amount of compensation provided to shareholders who perform services for the business may increase the shareholders' qualified business income (and section 199A deduction). See I.R.C. § 199A(c)(4)(A). As previously noted, however, some shareholders may benefit from the opposite strategy of overstating the amount of compensation if the W-2 wage limitation would otherwise be binding (see I.R.C. § 199A(b)(2)(B)), particularly if the shareholder already earns the maximum amount of wages subject to the 12.4 percent portion of the FICA tax.[12]

3. Page 32: add to note 2:

Under the 2017 tax law, an ESBT may have a "potential current beneficiary" who is a nonresident alien. See I.R.C. § 1361(c)(2)(B)(v) (last sentence).

4. Page 46: add to end of chapter two:

As described in chapter one, the 2017 tax legislation added new section 199A that is generally applicable to individuals who own a passthrough entity such as an S corporation. The legislation also placed a new limit on the deductibility of interest expense incurred by a business in taxable years after 2017, but generally only if the average annual gross receipts of the business for the preceding three years exceeds $25 million. See I.R.C. § 163(j). Thus, small and medium-sized businesses are generally exempt from the new limitation. Although the rule limiting the interest deduction applies to businesses organized in any form (C corporation or passthrough entity), special rules try to make the impact on S corporations (and partnerships) match the effect on sole proprietorships.

Under the new law, a taxpayer may generally deduct business interest only up to the sum of (1) the taxpayer's business interest income plus (2) 30 percent of the adjusted taxable income of the taxpayer for the year. The amount of interest expense not deductible by reason of this rule may be carried forward and deducted in future years (but subject to the same limitation). "Business interest" and "business interest income" generally refer to any interest expense (and income) properly allocable to a trade or business other than the business of performing services as an employee and certain other excluded businesses (including certain electing real estate or farm businesses). "Adjusted taxable income" means the amount of a taxpayer's taxable income without taking into account (1) income or loss not allocable to a trade or business, (2) business interest expense and income, (3) the net operating loss deduction, (4) the section 199A deduction, and (5) any deduction for depreciation, amortization, or depletion.[13]

In the case of a C corporation or sole proprietorship, the limitation applies to the corporation or individual proprietor, respectively. For S corporations and partnerships, the limitation applies to the entity with the consequences of that determination passed through to the entity's owners. As the following two examples illustrate, special rules are necessary to ensure that the entity's owners are generally treated in the same manner as a

[12] See note 7.

[13] After 2021, any deduction for depreciation, amortization, or depletion will be taken into account in computing adjusted taxable income. If this change is carried out, it will reduce adjusted taxable income and therefore tighten the constraint on the amount of business interest that may be deducted.

sole proprietor.

> **Example 2-3**: Assume that individual B owns all of the shares of an S corporation that is engaged in a covered business activity and has enough gross receipts to be subject to the new rule. The corporation has $10 million in adjusted taxable income, incurs $3 million in interest expense allocable to its business, and has no interest income. Under the new law, the section 163(j) limitation is applied at the S corporation level. Since 30 percent of the corporation's $10 million adjusted taxable income is $3 million, the limitation is not binding and the corporation is allowed to deduct all $3 million of its interest expense. The corporation therefore passes through $7 million of net taxable income to B ($10 million adjusted taxable income less $3 million interest expense). Absent any special rule, if this amount were included as part of B's adjusted taxable income for purposes of the interest limitation, B could deduct up to an additional $2.1 million (30% x $7 million) of interest expense for the year. B could, in effect, deduct (directly and indirectly) total interest expense of $5.1 million based on the total business income of $10 million. In contrast, had B operated the business as a sole proprietor, B would have been allowed to deduct a maximum of $3 million interest expense based on the same income. To avoid this double-counting problem, B's adjusted taxable income for purposes of the interest limitation generally does not include B's share of the S corporation's tax items. See I.R.C. § 163(j)(4)(A)(ii)(I) and (j)(4)(D). Thus, B may not deduct any further interest as a result of the S corporation income.

> **Example 2-4**: Same facts as in **example 2-3**, except that the S corporation incurs only $2.7 million in interest expense during the year. The section 163(j) limitation is again not binding and the corporation therefore deducts $2.7 million of interest expense and passes through $7.3 million net taxable income ($10 million adjusted taxable income less $2.7 million interest deduction) to B. If the entire $7.3 million is excluded from B's adjusted taxable income, the $10 million of business income would support only an indirect deduction by B of $2.7 million interest (through the S corporation). In contrast, had B operated the business as a sole proprietor, B would have been allowed to deduct a maximum of $3 million interest expense based on the same income. Accordingly, in determining the interest limitation, B's adjusted taxable income must be increased by her share of the S corporation's "excess taxable income," i.e., the amount ($1 million in this example) of the corporation's adjusted taxable income that could have been used to support an additional interest deduction. (The corporation "used" only $9 million of its adjusted taxable income since that amount sufficed to permit full deduction of its interest expense ($2.7 million = 30% x $9 million).) See I.R.C. §163(j)(4)(A)(ii)(II) and (j)(4)(C) and (D). Thus, B may deduct up to an additional $300,000 of interest expense that B incurs directly, resulting in a total direct and indirect deduction of $3 million.

As illustrated by these two examples, the statute limits the amount of a passthrough entity's adjusted taxable income that may be taken into account by an owner for purposes of applying the interest limitation to the owner. The statute is silent, however, on the amount of an entity's business interest income that may be taken into account by an owner for the same purpose even though, conceptually, the same double-counting issue might arise. The IRS has indicated that regulations will allow an owner to take into account for this purpose the owner's share of only the excess business interest income of a passthrough entity (i.e., its business interest income less its business interest expense) for the year. See Notice 2018-28, § 7, 2018-16 I.R.B. 492, 494.

The following **example 2-5** shows that the rules unfortunately do not always match the consequences of a passthrough owner with those of a sole proprietor.

> **Example 2-5**: Same facts as **example 2-3**, except that the S corporation incurs $3.3 million of interest expense. In this case, the $3 million section 163(j) limit is binding and therefore $300,000 of the interest cannot be deducted by the S corporation but must be carried forward and potentially deducted (and passed through to B) in the following year. Suppose, however, in the same year the S corporation has its income and interest expense, B has $1 million of adjusted taxable income (unrelated to her S income) and no interest expense. In this case, had B earned directly as a sole proprietor all of her $11 million business income ($10 million from the S corporation business and $1 million from her other business) and also incurred directly the $3.3 million interest expense, she could have deducted all of the interest in that year. A special carryforward rule applicable to partnerships does not solve this problem and is, in any event, not applicable to S corporations. See I.R.C. §163(j)(4)(B) and (D).

Other changes in the new law affecting the amount and timing of taxable income of both S and C corporations (and partnerships and proprietorships) are described in chapter three.

5. **Page 62: add new note 8 (and renumber existing note 8 as note 9)**:

8. *Principal business tax changes made by the 2017 tax legislation*. In addition to the changes already described in chapter one—including importantly the tax rate changes and the new section 199A deduction—the 2017 tax legislation made the following principal changes affecting businesses, generally effective for taxable years beginning after 2017. Except for the first item (applicable only to C corporations), these modifications affect both C corporations and individuals owning passthrough businesses (including sole proprietorships).

a. *Corporate AMT*: The new legislation repealed the corporate AMT but permitted C corporations to use their existing AMT credits to offset any amount of regular corporate income tax liability after 2017. In addition, in taxable years beginning in 2018, 2019, and 2020, corporations will be entitled to receive cash refunds equal to 50 percent of any AMT credits in excess of those used to offset regular tax liability in those years. In taxable years beginning in 2021, the refund amount will be 100 percent of any remaining unused credits. Thus, by the end of 2021, all AMT credits will be either used or refunded. See I.R.C. § 53(d)(2) and (3), (e).

b. *Net operating losses*: In general, net operating losses arising in taxable years after 2017 may no longer be carried back, and losses carried forward may offset a maximum of 80 percent of the taxpayer's taxable income (computed without regard to the section 199A deduction) in the carryforward year. Losses may be carried forward indefinitely, subject to the annual 80 percent limitation. See I.R.C. § 172.

c. *Expensing*: The new law increased the amount of certain capital investments that taxpayers may expense (i.e., immediately deduct in full), rather than depreciate. In general, taxpayers may expense 100 percent of the cost of certain new or used property placed in service after September 27, 2017 and before 2023. After 2022, the expensing percentage is reduced to 80, 60, 40, and 20 percent of the cost of qualifying property placed in service in 2023, 2024, 2025, and 2026, respectively. The taxpayer's basis in the property is immediately reduced by the amount expensed and any amount not expensed may be depreciated under the normal cost-recovery rules. Qualifying property generally includes most tangible property (other than buildings) and certain intangible property if used by the taxpayer in a trade or business or for the production of income. See I.R.C. § 168(k).

Congress has enacted "bonus depreciation" provisions in the past—generally limited to an initial deduction of 50 percent of the cost of qualifying property placed in service in the current year—in order to help stimulate capital investment. But prior law has generally restricted the allowance to property whose original use commenced with the taxpayer. The new law's extension of this benefit to acquisitions of used property is a significant expansion and will affect the decision to carry out certain mergers and asset acquisitions and to make the section 338 election (all generally discussed in chapter ten). Qualifying used property must not have been used previously by the taxpayer and must generally have been acquired by the taxpayer in a transaction that is taxable to an unrelated seller. In addition, expensing applies only to the "cost" portion of the taxpayer's basis in the used property acquired; basis resulting from application of an exchanged-basis rule does not qualify. See I.R.C. §§ 168(k)(2)(A)(ii) and (E)(ii), 179(d)(2) and (3); Reg. § 1.179-4(d).

In addition, the new law increased the amount that may be expensed under section 179, which generally benefits only smaller businesses. Under that provision, taxpayers may elect to expense the cost of certain property acquired for use in the active conduct of a trade or business. The deduction is limited to $1 million per year and may not exceed the amount of taxable income of the taxpayer from the trade or business. The $1 million cap is reduced dollar-for-dollar to the extent the total cost of all such property placed in service by the taxpayer during the year exceeds $2.5 million. Thus, if the taxpayer places in service $3.5 million or more of such property in a year, the section 179 deduction is reduced to zero. The $1 million limit and $2.5 million threshold are both indexed for inflation. Qualifying property generally includes depreciable tangible property (other than buildings) and certain intangible property acquired by "purchase" for use in an active trade or business (regardless of whether the taxpayer previously used the property). See I.R.C. § 179.

d. *Deductibility of interest*: The new law replaced former section 163(j) (generally limiting the deductibility by certain highly leveraged C corporations of interest on certain related party debt) with a new, broader limit on the deductibility of interest expense incurred by a business in taxable years after 2017, but only if the average annual gross receipts of the business for the preceding three years was over $25 million. Under the new law, a taxpayer may generally deduct business interest only up to the sum of (1) the taxpayer's business interest income plus (2) 30 percent of the taxpayer's adjusted taxable income for the year. The law applies to both C corporations and passthrough entities.

The statute explicitly excludes investment interest and income (as defined in section 163(d)) from the definitions of business interest expense and income. See I.R.C. § 163(j)(5) and (6). Confirming a footnote in the conference report, IRS regulations will specify that all interest expense and income of a C corporation qualifies as business interest expense and income for purposes of this rule. See Notice 2018-28, § 4, 2018-16 I.R.B. 492, 493-94. Other aspects of the new rule, including special provisions applicable to passthrough entities, are described at the end of chapter two (see supplement addition to text page 46).

e. *Deductions disallowed*: The new law repealed the deduction for income attributable to domestic production activities (former I.R.C. § 199) and denied a deduction for various expenses, including those for activities generally considered to be entertainment, amusement, or recreation (I.R.C. § 274(a)(1)(A)), certain local lobbying activities (I.R.C. § 162(e)), certain payments made at the direction of a government or specified nongovernmental entity relating to the violation of any law or investigation of such violation (I.R.C. § 162(f)), and any settlement, payout, or attorney's fees related to sexual harassment or sexual abuse if the payments are subject to a nondisclosure agreement (I.R.C. § 162(q)).

f. *Accounting changes*: The new law expanded the universe of businesses eligible for more liberal accounting method rules. In general, any business with average annual gross receipts for the preceding three years of $25 million or less is not required to use the accrual method, inventory accounting, or the percentage-of-completion method of accounting for certain small construction contracts, and is exempt from the uniform capitalization rules.

In addition, the new law revised the timing of income recognition for certain accrual method taxpayers. In general, such taxpayers must recognize income no later than the taxable year in which the income is taken into account as revenue in certain financial statements. See I.R.C. § 451(b)(1).

Finally, the new law codified the current IRS method of reporting income from advance payments for goods or services. Under the provision, accrual method taxpayers may elect to defer the inclusion of income associated with certain advance payments to the taxable year following the taxable year in which the advance payment is received, provided that that portion of the income is also deferred as revenue for financial accounting purposes. See I.R.C. § 451(c).

g. *Like-kind exchanges*: The new law generally limited the nonrecognition treatment of like-kind exchanges to exchanges of real property not held primarily for sale. See I.R.C. § 1031(a). The effect of this change on tangible personal property previously eligible for like-kind exchange treatment may be negligible because recipients of such property, if received in a taxable exchange, may be entitled to expense the full cost of the acquired property. Thus, the purchaser's tax savings from immediate expensing may fully offset the tax detriment to the seller even assuming the acquired property has a zero basis in the seller's hands. One exception—a possible unintended effect of the change in law—was to make the exchange of player contracts from the trading of professional athletes a taxable event. These transactions may have uncertain consequences due to the ambiguous value of the contracts and unavailability of the expensing deduction to the recipients.

6. **Page 65: add to note**:

As previously described in chapter one, the 2017 tax law retained tax rates of 0, 15, and 20 percent on qualified dividends and long-term capital gain but determined eligibility for those rates based on the amount of a taxpayer's taxable income:

Table 3-1A: 2018 Tax Rates on Qualified Dividends and Long-Term Capital Gain

Single individual who is not a head of household	Married individual who files a joint return	Tax rate
amount of taxable income		
$38,600 or less	$77,200 or less	0%
Over $38,600 but not more than $425,800	Over $77,200 but not more than $479,000	15%
Over $425,800	Over $479,000	20%

The 2017 legislation also reduced the corporate dividends-received deduction to between 50 and 100 percent, preserving roughly the pre-2018 effective tax rate (between zero and 10.5 percent) on C corporations receiving dividends from other domestic C corporations. See I.R.C. § 243(a). A corporation's capital gain is taxed at 21 percent, the same rate applicable to its ordinary income.

7. **Page 69: add to note 2**:

The exclusion of 100 percent of the gain (up to certain limits) from the sale of section 1202 stock was extended indefinitely at the end of 2015. See P.L. No. 114-113, Div. Q, § 126, 129 Stat. 3054 (2015). This provision may take on heightened importance after 2017 because of the combined effect of the 100 percent exclusion at the shareholder level with the dramatic lowering of the corporate tax rate to 21 percent.

8. <u>Page 75: add to note 1</u>:

The 2017 tax legislation generally expanded the number of executives covered by section 162(m), while removing the exceptions for commissions and other performance-based compensation. Thus, such compensation must be taken into account in determining whether a public corporation has exceeded the $1 million limit on deductible compensation.

9. <u>Page 76: add to note 3</u>:

In general, an employee who receives employer stock in connection with the performance of services must include the value of such stock in income at the earlier of the time the employee’s rights in such stock are (1) transferable by the employee, or (2) not subject to a substantial risk of forfeiture. The 2017 tax legislation created a new category of stock compensation that, at the election of certain employees, need not be reported as income even though the employee’s rights to the stock are vested (and not subject to a substantial risk of forfeiture). The income deferral is allowed for a maximum of five years; deferral ends sooner—and the value of the stock (as of the date it would have been taxable under section 83(a) but for the deferral election) must be included in income immediately—if the employee’s rights become transferable (including to the employer) or certain other events occur. See I.R.C. § 83(i).

In general, the provision applies only to stock received upon exercise of an option that was granted to the employee by a non-public corporation for the performance of services. A one-percent-or-greater owner of the corporation, certain of its top executives, and certain related family members within this group, are not eligible to make the election. The timing of any compensation deduction by the employer is deferred to match the income deferral to the employee. The new law includes certain additional conditions and reporting requirements.

10. <u>Page 83: add to note before Notice 97-21</u>:

As previously described (see supplement addition to text pages 46 and 62), the 2017 tax legislation repealed former section 163(j) and added a new, broader limitation on the deductibility of interest by C corporations and passthrough businesses.

11. **Page 96: add to note**:

After 2017, the AET and PHCT will assume enhanced importance because of the large potential advantage of accumulating earnings in a C corporation.

12. **Page 116: add to end of note 4**:

Dissatisfaction with the perceived impact of the U.S. tax law on the location of worldwide capital was an important driver behind the tax legislation enacted at the end of 2017. The concern related to both the actual location of capital and mere accounting mechanisms that resulted in the reporting of profits outside of the U.S.'s tax jurisdiction. One objective—to induce more foreign investment directly in the U.S. or through U.S. businesses (and to have more profits reported in the U.S.)—was a principal reason for reducing U.S. taxation of capital income. As discussed in chapter one, the new law dramatically lowered the U.S. corporate income tax rate to 21 percent and enacted new section 199A to reduce the capital income tax of U.S. businesses operated in passthrough form. These changes were not incompatible with either CIN or CEN principles.

The other objective—to discourage (or at least not encourage) the location of U.S. capital investment (and accounting profits) abroad—was trickier to attain because it potentially conflicted with CIN's goal of protecting the competitiveness of U.S. businesses investing outside the U.S. For example, immediate U.S. taxation of the worldwide income of U.S. taxpayers—supported by CEN principles—might seem to remove any tax reason to engage in foreign business activity, but at the possible cost of hurting the ability of U.S. businesses to compete abroad with foreign businesses not subject to a similar rule in their home jurisdiction. Congress was also concerned that the tax law (1) discouraged the repatriation of foreign earnings (the so-called "lock-out" effect, reportedly resulting in an accumulation outside the U.S. of over $2 trillion of foreign earnings of U.S. taxpayers as of the end of 2017), and (2) induced transactions in which some U.S. corporations became foreign corporations (sometimes termed "corporate inversions") to escape the adverse consequences of some of the U.S. tax rules. These and similar concerns (as well as concerted lobbying by the affected businesses) prodded Congress to approve a major change to the U.S. international income tax rules in 2017. In general, Congress adopted a modified "territorial" or "exemption" system—enacting essentially a different middle ground between CIN and CEN principles than existed previously—effective for taxable years beginning after 2017. While prior law deferred U.S. taxation of much foreign income pending its repatriation, the new law either imposes some immediate U.S. tax on foreign income when it is earned or none at all.

Under the new law, the active foreign earnings of certain foreign corporations owned by U.S. persons is generally exempt from U.S. tax. The key change from prior law was to exempt from U.S. tax on a going-forward basis the repatriation of this income from abroad, thus ending the lock-out effect for future active foreign earnings. See I.R.C. §

245A. A tradeoff for the tax exemption of *future* foreign earnings was current U.S. taxation of *past* foreign earnings not yet taxed by the U.S. Such earnings (whether repatriated or not) are generally taxed at rates of 15.5 and 8 percent for cash and non-cash accumulations, respectively; the tax is generally payable over a backloaded eight-year period without interest. See I.R.C. § 965.

In addition, Congress took several steps to discourage the exemption from inducing even more foreign investment by U.S. taxpayers (or locating even more U.S. profits abroad). First, it generally retained the subpart F provisions that result in current U.S. taxation (at the regular corporate rate of 21 percent) of certain categories of income of a CFC. In addition, Congress added a new category of income of a CFC (termed "global intangible low-taxed income" or "GILTI") that is also taxed currently by the U.S. but at half the regular corporate rate, or 10.5 percent. See I.R.C. § 951A. In general, GILTI is the above-routine portion of a CFC's return on tangible property plus the entire return on its intangible property. Although the GILTI tax thus applies to more than just income from intangible property, such income was especially targeted because of the ease with which intangible property can be located in a favorable tax jurisdiction. (This same rationale explains why certain categories of foreign income are subject to current U.S. tax under subpart F.) Congress permitted the U.S. tax on GILTI to be offset by a credit equal to only 80 percent of the foreign tax on the same income; as a result, GILTI must generally be subject to foreign tax of at least 13.125 percent before the U.S. residual tax is eliminated (80% x 13.125% = 10.5% foreign tax credit).

The new GILTI tax is a type of "stick" generally to discourage the location of intangible property outside the U.S., particularly in a low-foreign-tax jurisdiction. Congress also added a new "carrot" to encourage U.S. taxpayers to keep their intangible property in the U.S. Under the new law, certain GILTI-type income of a U.S. corporation derived from export sales or services to foreign persons (termed "foreign-derived intangible income" or "FDII") is taxed at only 13.125 percent (rather than 21 percent). See I.R.C. § 250. For example, royalty income from intangible property owned by a U.S. corporation but used by a foreign person would ordinarily qualify for the special low tax rate.

As you can see, if the GILTI stick and the FDII carrot work correctly and harmoniously, the net result might be to advance both CEN and CIN principles for a potentially large category of mobile income of U.S. multinationals, i.e., income from their intangible property. CEN might be satisfied because roughly the same tax rate—13.125 percent—would apply to intangible income regardless of whether the intangible property is located at home or abroad. Presumably, if that proves to be correct, most U.S. taxpayers would prefer to locate their property in the U.S. Meanwhile, CIN is appeased somewhat by the reduced tax rate on that category of income, thus improving the multinational's competitiveness against foreign corporations. A tax rate of 13.125 percent represents a 62.5 percent reduction from the previous corporate tax rate of 35 percent, although much of the prior 35-percent tax was deferred.

Finally, to further protect the U.S. tax base, Congress added one other major provision, commonly termed the “base erosion and anti-abuse tax” or “BEAT.” See I.R.C. § 59A. This tax is applicable only to certain large U.S. C corporations and generally equals 10 percent of certain deductible payments (such as those for interest, royalties, or services) made by a taxpayer to related foreign persons (broadly defined). In the absence of the tax, such payments might allow the U.S. tax base to be depleted at minimal cost to the taxpayer in the foreign jurisdiction. The BEAT is in addition to any other corporate tax imposed on the taxpayer.

It will be years before we have a good sense of the effectiveness of the new law in achieving its various objectives. In the meantime, taxpayers and their advisors will have their hands very full understanding and adapting to the new rules, and the government will be equally busy trying to provide interpretation and guidance while simultaneously enforcing the new tax law. Aside from implementation issues, the success of the new law will depend importantly on the reaction of foreign countries as well as the results of possible challenges to U.S. policy under the WTO.

13. <u>Page 132: add to note 1:</u>

In *Summa Holdings v. Comm’r*, 848 F.3d 779 (6th Cir. 2017), the Sixth Circuit recently interpreted the substance-over-form and economic-substance doctrines in a transaction occurring prior to the effect of codification of the economic substance doctrine in 2010. The taxpayers devised a strategy to fund Roth IRAs of their two sons with over $1 million each in 2008 even though contributions from the sons were barred in that year because of their high income. The source of the money was the taxpayer’s family-owned manufacturing C corporation (“Summa”) which transferred the money to a “domestic international sales corporation” (DISC) owned by the IRAs. The DISC then distributed a dividend of the money to the IRAs.

A DISC is a statutorily created special corporation that enables taxpayers to avoid paying tax on a portion of export income. By funneling the money from their corporation through a DISC to the IRAs, the taxpayers hoped to achieve two main tax objectives. First, the money transferred was deductible by Summa even though not taxable to the DISC, thus permitting the amount to escape corporate income tax liability (as authorized by the DISC provisions). Second, the transfer avoided the IRA contribution limitation. The IRS applied the substance-over-form and economic-substance doctrines to recharacterize the transaction as a dividend from Summa to the taxpayers followed by their contribution of the money to the IRAs. Under that view, no income avoided corporate tax (because the DISC was essentially disregarded), the dividend distribution was taxable to the taxpayers, and the taxpayers also owed an excise tax penalty for making an excessive contribution to the IRAs. Although the Tax Court upheld the IRS’s position, the Sixth Circuit reversed.

Both sides agreed that the transaction devised by the taxpayers had complied with the letter of the tax law. The Sixth Circuit recognized that it is sometimes necessary to recharacterize a transaction for tax purposes in order to help identify its economic reality. In this case, however, the court refused to recharacterize the transactions:

> The Commissioner's effort to reclassify [the] transactions as dividends [to the taxpayers] followed by Roth IRA contributions does not capture economic reality any better than describing them as [payments to a] DISC . . . followed by dividends to the DISC's shareholders. . . . This is not a case where the taxpayers followed a "devious path" to a certain result in order to avoid the tax consequences of the "straight path" . . . . Both paths involve two straightforward steps: a disbursement from Summa . . . (to either the DISC or the [taxpayers]) followed by a transfer to the Roth IRAs (either as a dividend or a contribution). 848 F.2d at 788.

The court essentially interpreted the government's position as simply trying to force the taxpayer to follow a higher-tax alternative structure rather than the equally plausible lower-tax one chosen by the taxpayer. The court conceded that the combined use of the DISC and Roth IRA provisions may have produced an unintended result, but indicated that it was not within the IRS's province to "correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take." Id. at 790. More generally, the court argued that the tax law in particular should normally be interpreted in a literal fashion:

> But if there is one title of the United States Code most deserving of attention to text, it is Title 26. . . . This is the highly reticulated Internal Revenue Code, which uses language, lots of language, with nearly mathematical precision. Is there any other title of the United States Code that has devoted more carefully drawn words to reducing its purpose to text? Perhaps the Commissioner's approach made some sense decades ago, when the Code was simpler . . . . But today, of all areas of law that should resist judicial innovation based on misty calls to higher purposes, this would seem to be it. Id. at 789.

The Sixth Circuit's opinion addressed Summa's appeal and permitted the corporation to deduct its payments to the DISC. The taxpayers (i.e., the shareholders of Summa) filed separate appeals in the First and Second Circuits to challenge the Tax Court's holding with respect to them. In Benenson v. Comm'r, 887 F.3d 511 (1st Cir. 2018), the court similarly rejected the IRS's position and reversed the Tax Court. The First Circuit stated that the substance-over-form doctrine is not a "smell test" but a tool of statutory interpretation.[14] After examining the language and legislative history of the DISC and Roth IRA provisions, the court concluded that both were congressionally designed tax reduction provisions and the taxpayers' transaction violated neither their letter nor spirit. The appeal to the Second Circuit is still pending.[15]

---

[14] The court specifically indicated that the case did not implicate the economic substance doctrine. See 887 F.3d __, n.3.

[15] In an opinion reviewed by the court (decided 12-4) involving essentially the same facts and issued after *Summa Holdings* but before *Benenson*, a majority of the Tax Court again held for the government but based on a narrower proposition that the Roth IRA was not the true owner of the stock of the tax-advantaged corporation (a foreign sales corporation, a congressionally created form with features similar to a DISC). The reason was the nominal amount the IRA paid for the stock and the resulting absence of any

14. Page 154: add to note:

Regulations under new section 163(j) will specify that the disallowance and carryforward of an interest deduction under that provision will not affect a corporation's computation of E&P. See Notice 2018-28, § 6, 2018-16 I.R.B. 492, 494. Presumably, E&P will therefore be reduced when the interest expense is incurred even though no tax deduction is allowed because of section 163(j). This treatment would be consistent with the current-law E&P treatment of losses that are recognized but not allowed as a deduction. See Reg. § 1.312-7(b)(1).

15. Page 161: add to description of dividends-received deduction:

The 2017 tax legislation changed the percentage for the dividends-received deduction to 50, 65, and 100 percent. See I.R.C. § 243. After taking into account the reduced corporate tax rate of 21 percent, the effective tax rate will thus generally be the same as under prior law for most dividend income received by a corporation.

16. Page 185: add new note 6:

The 2017 tax legislation provided two limited changes for the benefit of certain corporations that terminate their S status and become C corporations. First, any required adjustments under section 481 attributable to the switch (such as adjustments resulting from a change from the cash to accrual method of accounting) may be made ratably over six years (rather than the usual four years). Second, post-termination cash distributions from the new C corporation will be treated as distributions out of E&P or the former S corporation's AAA on a pro-rata basis. (As under prior law, cash distributions during the one-year period immediately following the S termination will continue to be treated as first from the AAA. See I.R.C. § 1371(e)(1).) The changes apply to corporations that had S status on the day before the enactment of the new law and revoke their election within two years after such date, but only if the same shareholders own the same interests in the corporation on the dates of enactment and revocation. See I.R.C. §§ 481(d), 1371(f).

17. Page 274: add to note 6:

The 2017 tax legislation eliminated the exclusion from a corporation's gross income for certain contributions in aid of construction; thus, a corporation may no longer exclude

---

risk assumed or expectation of future benefit. See Mazzei v. Comm'r, 150 T.C. No. 7 (2018). The case is appealable to the Ninth Circuit.

from income such contributions by a customer or potential customer, or by a governmental entity or civic group. See I.R.C. § 118(b).

18. <u>Page 280: add to note 3:</u>

The IRS withdrew the proposed regulations described in this note in 2017. See REG-139633-08, 2017-31 I.R.B. 175.

19. <u>Pages 345-46: add to note 4</u>:

The IRS issued final regulations under sections 334(b)(1)(B) and 362(e)(1) implementing the limitations on the importation of net built-in losses in 2016. See T.D. 9759, 2016-15 I.R.B. 545.

20. <u>Page 346, add to note 5</u>:

The IRS withdrew the proposed regulations described in this note in 2017. See REG-139633-08, 2017-31 I.R.B. 175.

21. <u>Page 353, add to section 3</u>:

New section 168(k) allows expensing of the full cost of most new or used tangible property (other than buildings) and some intangible property, if placed in service before 2023. This provision will change the consequences of taxable asset acquisitions, taxable mergers treated as asset acquisitions for tax purposes, and stock acquisitions treated as asset acquisitions under section 338. If the buyer and seller are in the same tax bracket and the buyer can immediately use any deductions arising from the transaction, the tax benefit to the buyer from expensing any section 168(k) property acquired should ordinarily offset the tax cost to the seller even if the seller has a zero basis in the property transferred, effectively producing the combined effect of a tax-exempt transaction. (Of course, the specific impact on each individual party will depend upon how the seller's tax cost and the buyer's tax benefit are shared in the pricing of the property acquired.) If the seller has a positive basis in the property transferred (for example, the property was placed in service before the effect of the new law and has not yet been fully depreciated), then the transaction should ordinarily produce a net tax benefit to the two parties. Unrelated taxpayers holding pre-effective date assets with a positive basis may have an incentive to engage in taxable swaps with one another to realize the tax benefit. The new statute does not include any anti-churning rules designed to prevent such behavior (other than disqualifying an acquisition if it is from a related party or consists of used property previously used by the acquiring party). It is difficult to understand the economic benefit of such transactions other than providing fees to the professionals who arrange them.

One uncertainty concerns whether a shareholder who is distributed eligible property in a taxable liquidation of a corporation can take advantage of section 168(k). Although the liquidating corporation is treated as having sold the property to the shareholder for its fair market value (I.R.C. § 336(a)), the shareholder is simply provided with a fair market value basis in the property distributed (I.R.C. § 334(a)). Should the shareholder be treated as placing the property in service for purposes of section 168(k)? Or might the property be considered ineligible used property because it was previously used by the shareholder (through the corporation)? See I.R.C. § 168(k)(2)(A)(ii) and (iii) and (E)(ii)(I).[16] If the shareholder cannot expense the fair market value basis of the property distributed, the shareholder should be able to obtain a roughly equivalent benefit by transferring the property for its fair market value to an unrelated buyer (depending upon how much of the tax benefit the buyer retains). Alternatively, if the shareholder wants to retain the property (and it is not viewed as "previously used" property), the shareholder could first borrow funds to purchase the property from the corporation and then receive back the borrowed money in the liquidation (and repay the loan).

In general, to the extent a corporation holds property qualifying for the section 168(k) benefit, it would seem that the three acquisition patterns described in this chapter—(1) a taxable corporate liquidation followed by a shareholder sale of the assets distributed (the pattern approved by the Supreme Court in *Cumberland*), (2) a taxable corporate sale of assets followed by a liquidation of the selling corporation (the pattern approved by the Supreme Court in *Court Holding Company*), and (3) a taxable stock sale (with or without a section 338 election)—would all seem to produce the same net tax consequence of a single tax imposed at the shareholder level. In other words, until 2023, the new law would seem to have partially reversed the repeal of *General Utilities*. Of course, the new law in fact may be viewed as accomplishing much more—shifting the tax law further away from income taxation toward consumption taxation—with the repercussions on *General Utilities* repeal being simply a manifestation of this broader shift in the context of a corporate acquisition. In any given case, the specific result will depend upon how much of the target corporation's property may be expensed under section 168(k), the parties' tax profile, and other factors.

Issues such as the proper characterization of a transaction as a stock or asset acquisition and the proper allocation of purchase price to any property acquired may continue, although with modified stakes. For example, if the seller is entitled to a capital gain preference, the seller may still prefer to characterize a transaction as a sale of stock

[16] Except for the "previously used" question, the shareholder's receipt of the property would not seem to violate any of the conditions in sections 168(k)(2)(E)(ii) and 179(d)(2) and (3). Although a shareholder is under some circumstances treated as related to a corporation under section 267 (see I.R.C. § 267(b)(2)), that relationship would not bar recognition of a loss in the liquidation by either the corporation or the shareholder. See I.R.C. § 267(a)(1), second sentence. Hence, related-party status should not prevent the distributee from obtaining the section 168(k) benefit. See I.R.C. §§ 168(k)(2)(E)(ii)(II), 179(d)(2)(A).

rather than assets even though the buyer may prefer the opposite characterization. If assets are acquired, the seller may prefer an allocation of consideration to assets qualifying for capital gain treatment whereas the buyer would ordinarily prefer an allocation that maximizes the section 168(k) allowance.

22. Page 364, add to section 4a:

New section 168(k) may affect the sections 338(g) and 338(h)(10) elections differently. If the section 338(g) election is made, the "old" target is deemed to have sold all of its assets for fair market value to an unrelated "new" target in a single transaction, and the new target is responsible for the tax consequences of the deemed asset sale and repurchase. See I.R.C. § 338(a); Reg. § 1.338-1(b)(1) (new target is not related to old target for purposes of section 168), -1(b)(3)(i) (new target responsible for old target's tax liability). Thus, if old target has a zero basis in assets eligible for section 168(k), new target's expense deduction should exactly offset old target's gain, producing a "wash" if section 338 is elected. If old target has a positive basis in its assets, then the net tax benefit from expensing exceeds the net tax detriment from gain recognition. In short, if most of old target's property qualifies under section 168(k), the tax stakes of making or not making a section 338(g) election may often be quite small.

The consequences of making a section 338(h)(10) election under the new law are different. The effect of the deemed sale and repurchase by the target may again be largely a wash to the extent the target holds assets eligible for section 168(k). The election also allows the seller of the target stock, however, to avoid recognizing gain or loss in the transaction. See I.R.C. § 338(h)(10)(A). Thus, this election would seem in many cases to be quite advantageous to taxpayers (and may produce the equivalent tax benefit of a "reorganization" (see chapters 11 and 12) without satisfying any of its conditions). For the same reason, the section 336(e) election (described in section (b) on p. 367 of the text) should almost always be made.

23. Page 366: add to note 3:

The 2017 tax legislation allows corporations to carry forward their net operating losses indefinitely. Thus, a section 338(g) election should generally not be made for target corporations with losses since the election terminates any losses not used in the transaction. As previously discussed (see supplement addition to text page 364), a section 338(g) election may generally produce a wash to the extent the target holds assets eligible for section 168(k).

24. Page 368: add to section c:

In the future, new section 168(k) may enhance the advantage of using an intermediary. Sellers entitled to a capital gain preference may still prefer to sell stock of their corporations. If an intermediary buys the stock, sells the corporation's assets to a buyer, and avoids paying tax on the gain from the asset sale, the buyer may receive an even greater tax benefit (from expensing the cost of acquisition) than was available under pre-2018 law.

25. Page 372: add to section C:

For reasons previously described (see supplement addition to text pages 353 and 364), section 168(k) has changed the consequences of selling and liquidating S corporations to the extent they hold assets eligible for expensing. In this situation, either a corporate liquidation or sale of assets should generally produce no net tax cost after taking into account the tax benefit to the distributee or acquiring party. But gain of the S corporation in the transaction would still pass through and increase shareholder basis in the S corporation stock. Hence, the transaction should also result in no net tax cost at the shareholder level. In other words, the "single tax" generally imposed under subchapter S may be eliminated to the extent buyers are entitled to expense the full cost of the acquisition. In a sale of an S corporation's stock, the section 338(h)(10) election should generally be made to achieve the same result.

If the S corporation has a built-in gain subject to section 1374 at the time of the acquisition, the corporate-level tax cannot be avoided even if the built-in gain assets qualify under section 168(k). In this situation, the law effectively imposes two immediate taxes on the corporation's gain, but only one of these taxes would be offset by the tax benefit from the buyer's expensing deduction. Thus, there should remain one tax on built-gain that would be passed through to the shareholders, eliminating any further tax consequences at the shareholder level.

26. Page 376, add to note 7:

The IRS finalized the temporary regulations under section 337(d) in 2018 with only minor, nonsubstantive changes. See T.D. 9833, 2018-__ I.R.B. __.

27. Page 398, add to note 4:

The IRS withdrew the proposed regulations described in this note in 2017. See REG-139633-08, 2017-31 I.R.B. 175.

28. <u>Page 453: add to section b</u>:

The IRS issued final regulations under sections 334(b)(1)(B) and 362(e)(1) implementing the limitations on the importation of net built-in losses in 2016. See T.D. 9759, 2016-15 I.R.B. 545.

29. <u>Page 484: add new note 6 before section 5</u>:

6. *"North-south" transactions*. The fact pattern in Rev. Rul. 2017-09, 2017-21 I.R.B. 1244, raises nicely the step-transaction doctrine and illustrates what is sometimes referred to as a "north-south" transaction. The facts involved a three-tier, wholly-owned corporate structure: P owned all the stock of D which owned all the stock of C. On date 1, P transferred an active business worth $25x to D in exchange for additional D stock. On date 2, for valid business reasons, D distributed all of its C stock (worth $100x) to P. Following the distribution, D retained and continued the active business transferred to it by P, and C continued the active business it held throughout. Prior to date 1, however, D did not have an active business (other than C's business). The purpose of P's transfer was to enable D to qualify for the active trade or business requirement of section 355(b)(1)(A). The precise timing of the two transfers was not specified.

The question presented was whether the two transfers should be respected as separate or integrated into a single transaction. As separate steps, each would qualify for tax-free treatment: the first under section 351 and the second under section 355 (assuming the other requirements of section 355 were satisfied). But if the steps were integrated, the transaction could be viewed as an exchange between P and D in which P transferred a $25x business to D in exchange for $25x worth of C stock. Under this approach, the exchange would ordinarily be taxable to both P and D. D then would be treated as distributing the remaining $75x of C stock to P as a dividend. Since that stock would represent less than 80 percent control of C, D's distribution would not qualify under section 355 and therefore would also be taxable.

Although the form chosen by the taxpayers consisted of two separate transfers, arguably the substance of what transpired was a single transaction since the first step was carried out to qualify the second step for special tax treatment under section 355. Under either the "mutual interdependence" or "end result" tests, it is quite possible the steps would be integrated. The IRS concluded, however, that the steps should be respected as separate. The IRS looked beyond the intent of the parties and articulated a novel test dependent on the policy of the affected code provisions:

> The determination of whether steps of a transaction should be integrated requires review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent

with the underlying intent of the applicable Code provisions. 2017-21 I.R.B. at 1246.

In reaching its conclusion, the IRS emphasized several points: (1) P's transfer to D was the type of transfer to which section 351 was intended to apply; (2) analysis of the transaction as a whole did not indicate that P's transfer should be recharacterized as part of an exchange; (3) each step resulted in continued ownership of property in modified corporate form; and (4) the steps did not resemble a sale and none of the interests were liquidated or redeemed. The steps were therefore consistent with the policies underlying sections 351 and 355 and should be respected as separate. It remains to be seen how the IRS will apply this test to subsequent transactions or how the courts will react to and interpret it. Based on the recent *Summa Holdings* case (see supplement addition to text page 132), it seems unlikely that the Sixth Circuit would view favorably the IRS's broad assertion of discretion. The IRS concluded the ruling with the somewhat ominous statement that "the Service may decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case."

30. <u>Page 509: add to section A.1</u>:

The 2017 tax legislation generally ended the carryback of net operating losses but permitted them to be carried forward indefinitely. Losses carried forward may offset at most 80 percent of the taxpayer's taxable income in the carryforward year. See I.R.C. § 172. While new section 168(k) may increase the amount of NOLs due to expensing, the interest deduction limitations in new section 163(j) may offset this effect to some extent.

31. <u>Page 529: add to note 1</u>:

If a loss corporation owns depreciable property at the time of an ownership change, Notice 2003-65 provides that its built-in amounts recognized within five years of the change date are generally determined by comparing the corporation's actual depreciation deduction each year with its hypothetical deduction had the property been purchased for its fair market value on the change date. In general, the excess of the actual deduction over the hypothetical deduction would constitute a recognized built-in loss for the year (made subject to the section 382 limitation), while the excess of the hypothetical deduction over the actual deduction would constitute a recognized built-in gain for the year (increasing the section 382 limitation for the year). In Notice 2018-30, 2018-21 I.R.B. 610, the IRS announced that the hypothetical deduction for this purpose should be determined without regard to new section 168(k) (allowing expensing of the full cost of certain qualified property). In general, without this modification, the amount of a loss corporation's recognized built-in gain from section 168(k) property would have increased and the amount of its recognized built-in loss from the same property would have been largely eliminated.