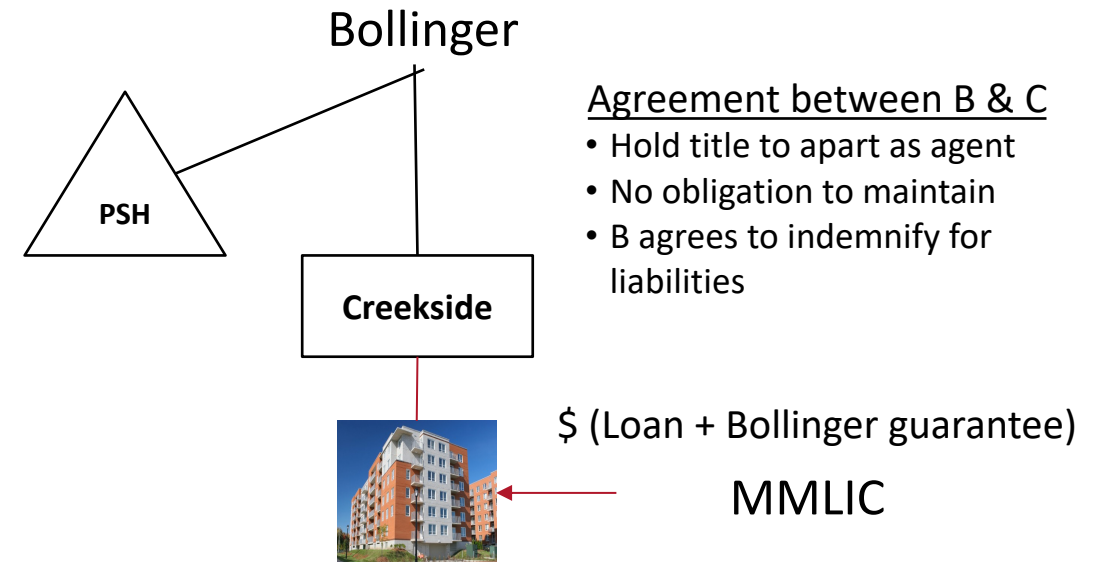


# C Corporations: Commissioner v. Bollinger

- *Moline Properties v. CIR*, 319 U.S. 436 (1943)
  - Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, **so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity...** The choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages.
- *National Carbide Corp. v. CIR*, 336 US 442 (1949)
  - [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal, by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. **[5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.**



# C Corporations: Individual and Tax Rates for 2021

C Corporations	MTR
Any income	21%

## 2022 Tax Brackets for Single Filers, Married Couples Filing Jointly, and Heads of Households

2022 Tax Rate	For Single Filers	For Married Individuals Filing Joint Returns	For Heads of Households
10%	\$0 to \$10,275	\$0 to \$20,550	\$0 to \$14,650
12%	\$10,275 to \$41,775	\$20,550 to \$83,550	\$14,650 to \$55,900
22%	\$41,775 to \$89,075	\$83,550 to \$178,150	\$55,900 to \$89,050
24%	\$89,075 to \$170,050	\$178,150 to \$340,100	\$89,050 to \$170,050
32%	\$170,050 to \$215,950	\$340,100 to \$431,900	\$170,050 to \$215,950
35%	\$215,950 to \$539,900	\$431,900 to \$647,850	\$215,950 to \$539,900
37%	\$539,900 or more	\$647,850 or more	\$539,900 or more

## 2022 Capital Gains Tax Brackets

	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
0%	\$0	\$0	\$0
15%	\$41,675	\$83,350	\$55,800
20%	\$459,750	\$517,200	\$488,500

## C Corporations: Miscellaneous

- All C corporations taxed at the same 21% rate.
- Capital losses
  - Deducted only to extent of capital gains;
  - Excess CLs can be carried back 3 years and forward 5 years. §§1211(a); 1212(a)(1)(C).
- Dividends received deduction: 50%, 65%, and 100%. §243(a)-(c)
  - Is an S Corp entitled to the DRD?
- Charitable deduction: 10% of TI (specially computed). §170(b)(2)
- *Net Operating Losses:*
  - Excess of deductions over GI (computed with special modifications). §172(c)
  - NOLs can be **carried forward indefinitely** and can offset up to **80% of TI**. §§172(a)(2) and 172(b)(1)(A)(ii)(II).
  - Compare treatment of losses in S Corp (and PSH) with C Corp.

### ■ Section 1501

- Affiliated group of US corporations can file a consolidated return
- Affiliated group: 80% vote & value (§1504), excluding tax-exempts & FCs

### ■ Section 1561

- Treats all corporations that are members of a “controlled group of corporations” as *one* for purposes of the **accumulated earnings tax**.
- Controlled Group of Corporations
  - Parent-Subsidiary
  - Brother-Sister (§1563(a))
- Excluded Corporations and Stock
  - Tax-exempts
  - Foreign Corporations
  - Non-voting Preferred Stock (§1563(b) and (c))
- Constructive Ownership Rules (§1563(e))

### ■ Section 163(j)

- Applies to taxpayers, including all *tax shelters*, with average 3-yr, annual *gross receipts* > 25mm. §§163(j)(3); 448(c)(1)
- Business interest deduction limited to the sum of:
  - *Business interest income*, and
  - *30% of Adjusted Taxable Income*. §163(j)(1)
- ATI (close to EBITDA): TI computed *without regard to*:
  - business interest and business interest expense,
  - Non-business income, gain, deduction, or loss,
  - NOLs, and
  - Depreciation (for pre-Jan. 1, '22 TYs). §163(j)(8)
- Any disallowed interest is treated as business interest paid/accrued in the succeeding taxable year. §163(j)(2)

## C Corporation Taxation: Sections 168(k) and 179

- *Qualified Property* placed in service aft. 9/27/17 and **bef. 2023** is eligible for **100% depreciation deduction** (20 percentage point reduction for each subsequent year). §168(k).
- ***Qualified Property***
  - Tangible Property with recovery period of **20 years or less**
    - What type of property is excluded?
  - Qualified film or TV production, qualified live theatrical production
  - **Original use or acquisition** by taxpayer, provided that the acquisition isn't from a related person or received on an exchanged basis.
- Section 179 expensing amount for QP increased to 1mm (phaseout threshold: 2.5mm)
  - QP: tangible personal property, SW, and qualified real property (qualified improvement property and (for nonresidential RP) roofs, heating, ventilation, and AC, fire property, and alarm & security system. § 179(f).
- What is the economic effect of a 100% deduction for the purchase of a capital asset?

## Benefits of 100% Expensing

- For an asset whose purchase price would otherwise have to be capitalized, a 100% deduction is equivalent to exempting the income produced by the asset from tax. The first column assumes that you earn \$100 (pre-tax) and you purchase stock for \$63, which is the amount you can invest after tax. The gains--\$6.30--we assume are exempt. The second column assumes that you deduct the purchase price of the stock and thereby eliminate tax on your \$100 of income, but all of the gains (both the investment and return) are taxed. You'll see that the final amounts are equal. In your basic tax class, this is similar to the equivalence of accumulations in a Roth IRA (no deduction/no tax) and regular IRA (deduction/tax), given similar tax rates at the time of contribution and distribution.

	Tax Rate	37%
	Invest Ret	10%
Income	100.00	100.00
Tax	<u>(37.00)</u>	<u>0.00</u>
AT Inc Invested	63.00	100.00
Return	6.30	10.00
Tax	<u>0.00</u>	<u>(40.70)</u>
Total AT Amount	69.30	69.30

# C Corporations: Taxation of C Corp Investors

## ■ Individuals:

- Maximum rate on dividends: 23.8%.
- Maximum rate on CGs: 23.8%.
  - 20% rate on CGs and dividends kicks in when TI > 459,750 (or 517,200 for joint returns) §§1(h)(1)(D) and(11)
    - Note: Dividend rate applies to entire dividend; CGs rate applies only to gains and not to gross receipts (taxpayers recover basis first)
  - 3.8% rate on net investment income (divs, CGs) kicks in when AGI > 200,000 (individuals) or 250,000 (joint return). §1411.

## ■ Corporations:

- CGs taxed at same rate as business income
- Can deduct between 50% and 100% of dividends received from other corporations
  - Ex. 100 div minus 50 deduction = 50 TI;  $50 * 21\% = 10.5\%$



## C Corporations: Special Rules for Qualified Small Business Stock (§1202)

- Noncorporate taxpayers can exclude **100% of the gain** from the **S/E of *qualified small business stock (QSBS)*** acquired after 9/27/10 (50% or 75% if acquired before) and **held for more than 5 years**. §1202(a)(1) and (4).
  - For stock eligible for the 100% exclusion, there is no AMT add back and the 3.8% tax doesn't apply.
- **Limit: Greater of:** (1) \$10MM per issuer; **or** (2) 10 x adjusted basis of the stock issued and disposed of by taxpayer during the year. §1202(b)(1).
- QSBS is **C corporation stock** of a *qualified small business* (QSB) acquired at **original issue** in exchange for **\$, property, or services**. §1202(c)(1)
- QSB: **Aggregate gross assets don't exceed \$50mm after issuance**, and **80% of assets** are used in the conduct of 1 or more businesses **other than** health, law, banking, investing, a t/b where the principal asset of the the t/b is the reputation or skill of 1 or more its employees, farming, operating a hotel, motel, holiday inn, or restaurant. §§1202(d)(1)(B); 1202(e)(3).

## C Corporations: Section 1244 and Small Business Corporations

- Up to 50k/yr (100k for MFJ) on S/X of **section 1244** stock is treated as ***ordinary loss***; any excess is treated as capital loss
  - Benefit?
- Sec. 1244 stock
  - Corporation (*including S Corp*) was **small business corporation**;
  - Stock issued for money or property (**not** services); and
  - For 5-yr period ending before the date of loss, the corporation derived more than 50% of its aggregate gross receipts from non-passive sources (i.e., not dividends, interest, rents, and royalties). §1244(c)(1).
- Small Business Corporation
  - Aggregate money and other property received by the corporation for stock, contribution to capital, and paid-in surplus does not exceed \$1MM. §1244(c)(3)(A).

## C Corporations: Section 1045 and Sales of Small Business Stock

---

- In the case of a sale by a noncorporate taxpayer of *qualified small business stock* held for **more than 6 months**, gain is recognized only to the extent that the amount realized exceeds the cost of QSBS purchased within 60 days of the sale. §1045(a)(1).
  - QSBS is defined by reference to §1202(c).
  - Any gain not recognized because of this provision reduces the basis of the purchased QSBS stock. §1045(b)(3).
- Why?

## C Corporations: Avoiding Corporate Tax with Compensation

- What are the tax consequences to the corporation *and* shareholder when the corporation pays a salary to the shareholder?

### SEC. 162. TRADE OR BUSINESS EXPENSES.

#### [Sec. 162(a)]

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

Reg. §1.162-7

- When is it beneficial for a corporation to pay the shareholder a salary vs. paying a dividend?



## C Corporations: Avoiding Corporate Tax with Compensation

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example,

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

**Reg. §1.162-7(b)(1), (3)**

# Compensation

## ■ Federal Income

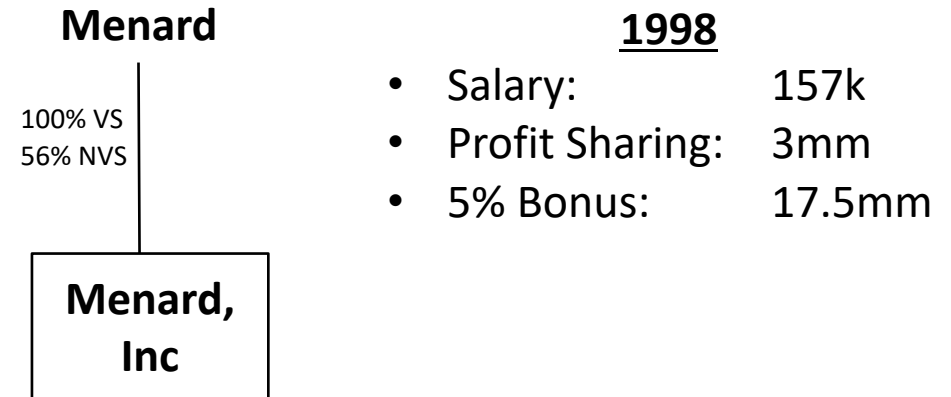
- Compensation is generally taxed as ordinary income
  - But note special rules of §199A
- Investment income: 3.8% tax on **investment income**, e.g., dividends, interest, rents, royalties. §1411.
  - > \$200,000 (single), \$250,000 (joint)

## ■ Social Security

- 7.65% [6.2% (OASDI) + 1.45% (Medicare)] **to** \$160,200 (2023) (employers & employees, each). §§3101(a) and (b)(1); 3111(a) and (b).
- 1.45% (employer & employee) on earned income > \$160,200 (2023). §§3101(b)(1) and 3111(b).
- 0.9% Medicare tax (employee) on earned income > \$200,000 (single); 250,000 (joint). §3101(b)(2)

## C Corporations: *Menard* (Avoiding Corporate Tax with Compensation)

- What was the 5% bonus?
- When was it adopted?
- What were some of the factors that the IRS and TC argued that the 5% bonus should be treated as a dividend?
- According to J. Posner, was it relevant that Menard's didn't pay a dividend?
- The TC focused on the compensation paid to comparable companies, e.g., Home Depot and Lowe's. Why didn't J. Posner put much weight on this?
- What test does the 7<sup>th</sup> Cir use to determine whether compensation is reasonable?



### The Tax Stakes

<b>TC</b>	<b>21%</b>	<b>TSH Div</b>	<b>20%</b>
<b>TSH</b>	<b>37%</b>	<b>Payment</b>	<b>20,000,000</b>
<b>Medicare</b>	<b>3.80%</b>	<b>NII</b>	<b>3.80%</b>

	<b>All Comp</b>	<b>All Dividend</b>
<b>Corp</b>	<b>0</b>	<b>4,200,000</b>
<b>SH IT</b>	<b>7,400,000</b>	<b>3,160,000</b>
<b>SH NII</b>		<b>600,400</b>
<b>SH Med</b>	<b>760,000</b>	
<b>Total</b>	<b>8,160,000</b>	<b>7,960,400</b>

# C Corporations: Avoiding Corporate Tax with Compensation

## ■ Public Companies

- No deduction for *applicable employee remuneration* for *covered employee* of publicly held corporation (including foreign corporations with US traded equity) **or** U.S. corporations that issue publicly traded debt in excess of \$1MM. §162(m)(1).

## ■ Covered Employee

- CEO and CFO
- Top 3 highest compensated officers (other than CEO or CFO). §162(m)(3).
- Once covered, always covered

## ■ Applicable Employee Remuneration

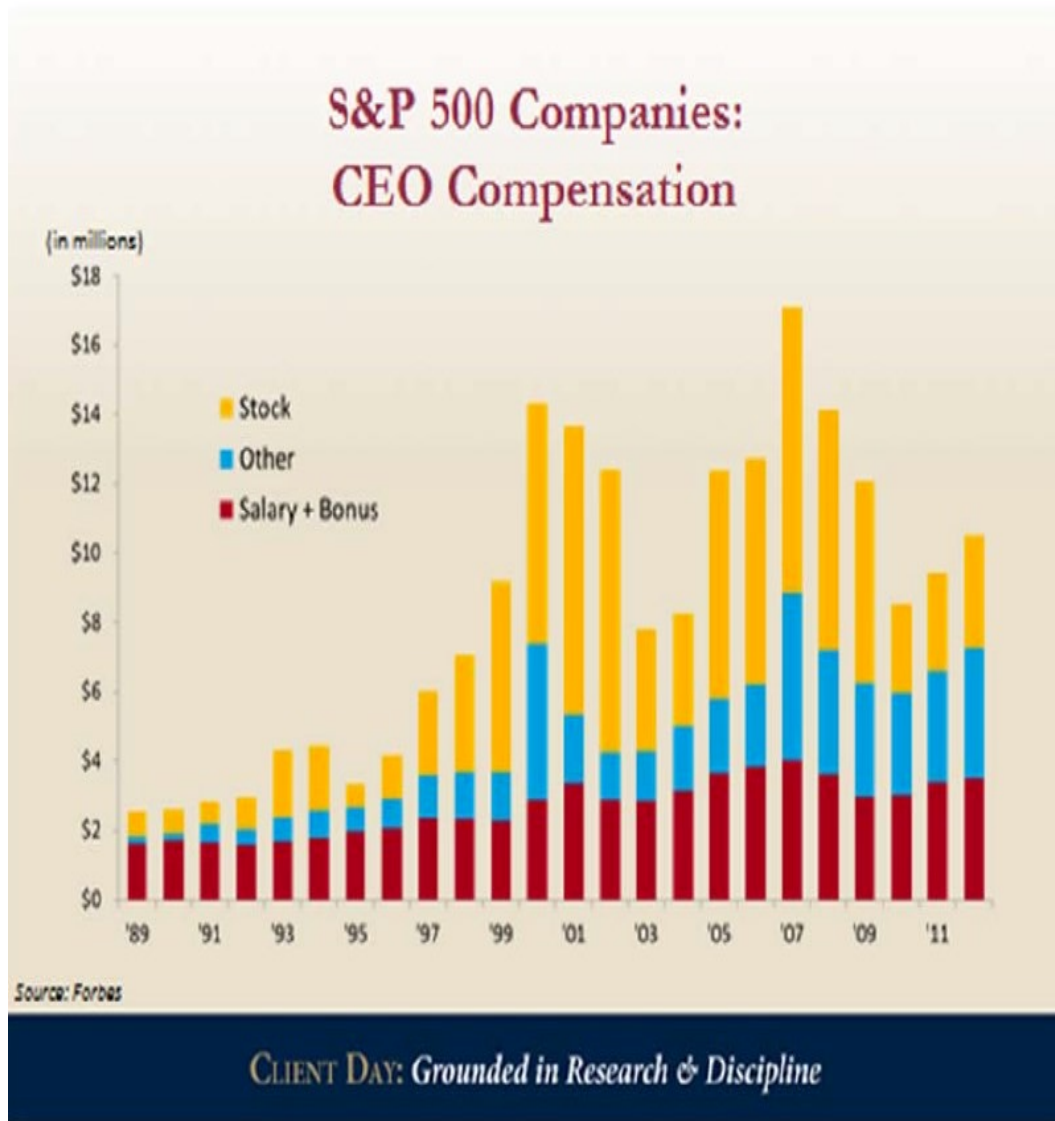
- Aggregate amount allowed as a deduction for remuneration for services
- Final Regs issued on 12/30/20

### Grandfathered for pre-Nov. 2, '17 contracts:

- Deductible remuneration for services, except:
  - remuneration payable solely on account of the attainment of one or more performance goals, if:
    - Performance goals determined by a compensation committee of the BOD comprised solely of 2 or more outside directors
    - Material terms disclosed to SHs and approved by a majority of the vote
    - Compensation committee certifies that the performance goals satisfied. Former §162(m)(4)(C).



# C Corporations: Avoiding Corporate Tax with Compensation



*There is little evidence that the deductibility cap has had significant effects on overall executive compensation levels or growth rates at firms likely to be affected by the deductibility cap, however, nor is there evidence that it has increased the performance sensitivity of CEO pay at these firms. We conclude that corporate pay decisions seem to be relatively insulated from this type of blunt policy intervention.*

*Rose & Wolfram, Regulation Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation, J. of Labor Econ. (2002)*

## C Corporations: Avoiding Corporate Tax with Compensation

- **Tax Considerations.** Section 162(m) of the Internal Revenue Code limits the Company's ability to deduct compensation in excess of \$1,000,000 paid in any year to the Company's named executive officers. The HR Committee adopted performance goals so that awards made pursuant to such goals that contributed to a named executive officer earning more than \$1 million in annual compensation may qualify as tax deductible to the Company for U.S. federal income tax purposes under Section 162(m). In December 2017, the U.S. federal government enacted the Tax Cuts and Jobs Act, which ...eliminated the performance-based compensation exception under Section 162(m). **As a result, the Company expects that, except to the extent an exception applies, any compensation over \$1 million paid to any current or future named executive officer in a fiscal year will not be tax deductible.** The HR Committee certified certain performance measures in December 2017 to protect a portion of the tax deduction for performance based compensation that would be paid in February and March 2018 to the Company's named executive officers.

## C Corporations: Avoiding Corporate Tax with Compensation

- **Nonqualified Stock Options** (options without a *readily ascertainable FMV*)
  - Bargain element (difference btwn exercise price and share value) is taxed upon **exercise**. §83; Reg. §1.83-7(a).
  - Corporation receives deduction in the same amount as employee inclusion when the employee reports the income. §83(h).
- **Incentive Stock Options (ISOs)**
  - Bargain element taxed when employee disposes of shares at capital gains rates
  - No deduction for corporation
  - Upon exercise, bargain element is AMT add back. §56(b)(3).
  - 100k annual limit. §§421 and 422.
- **Financial accounting treatment**
  - Recognized as expense (FMV) when **granted**. If not vested at grant, FMV recognized over the vesting period.

## C Corporations: Avoiding Corporate Tax with Compensation

- **Stock** granted in exchange for services
  - Includible in income (and deductible by issuing corporation) when “vested”:
    - stock is transferable, or
    - not subject to substantial risk of forfeiture, e.g., future performance of services
  - Section 83(b) election for nonvested stock, but generally not for nonqualified options
    - FMV currently included in income (and deductible by employer), and
    - Any subsequent gain recognized is capital gain
- **Qualified Equity Grants** (new §83(i))
  - **Qualified stock:** received in connection with the exercise of an option or settlement of a RSU from an eligible corporation
  - **Eligible Corporation:** Non-publicly traded and 80% or more of all employees are granted stock options/RSU
  - **Deferral Option:** e/ee can elect to defer QS until the earliest of: it becomes transferable; the stock becomes tradable on an exchange; or 5 years after vesting
  - Any increase in value after the election date is taxed at capital gains rate

## C Corporations: Capital Structure

---

- Interest paid by a corporation on indebtedness is generally deductible, subject to certain limitations, such as section 163(j), by a corporation in computing its taxable income. §163
  - Is leverage always beneficial to a firm?
    - Consider the profitability of firm
  - Is leverage always beneficial to a firm's shareholders?
    - Taxation of dividends vs. taxation of interest
  - What are some of non-tax burdens of leverage?
    - Covenants?

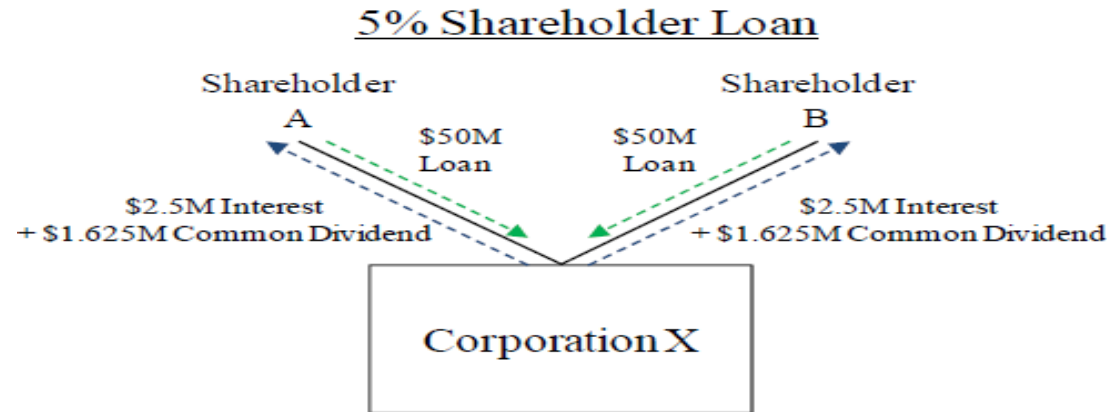
### ■ Section 163(j)

- Applies to taxpayers, including all *tax shelters*, with average 3-yr, annual *gross receipts* > \$25MM. §§163(j)(3); 448(c)(1)
- Business interest deduction limited to the sum of:
  - *Business interest income*, and
  - *30% of Adjusted Taxable Income*. §163(j)(1)
- ATI (close to EBITDA): TI computed *without regard to*:
  - business interest and business interest expense,
  - Non-business income, gain, deduction, or loss,
  - NOLs, and
  - **Depreciation** (for pre-Jan. 1, '22 TYs). §163(j)(8)
- Any disallowed interest is treated as business interest paid/accrued in the succeeding taxable year. §163(j)(2)

# C Corporations: Capital Structure (Pre-TCJA Example)

Corp X needs to raise \$100mm of capital and must decide between issuing debt or preferred stock @ 5% to its shareholders

Assume shareholders are in the 43.4% tax bracket.



## Loan Results:

Gross income = \$10M

Interest expense = \$5M (\$2.5M paid to each)

Taxable income = \$5M (\$10 - \$5 deductible interest)

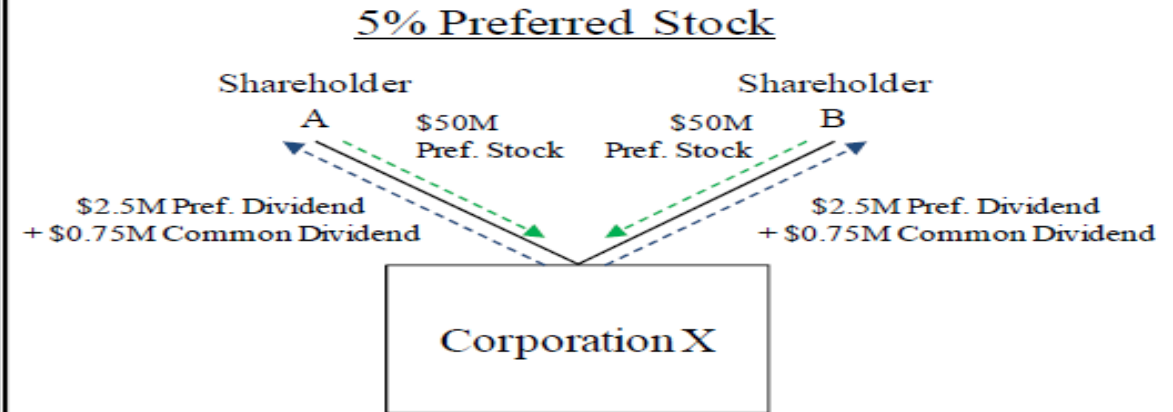
Corporation pays **corporate tax** of **\$1.75M**  $((10-5)*35\%)$

Together, Shareholder A and B pay **individual tax**

- on interest of **\$2.17M**  $(5*43.4\%)$  and
- on dividends of **\$0.77M**  $((10 - 5 - 1.75)*23.8\%)$

**Total Tax Paid = \$4.69M**

**Net Return from \$100M Investment = \$5.31M**



## Preferred Stock Results:

Gross income = \$10M

Pref. dividend paid = \$5M (\$2.5M paid to each)

Taxable income = \$10M (dividends not deductible)

Corporation pays **corporate tax** of **\$3.50M**  $(10*35\%)$

Together, Shareholder A and B pay **individual tax**

- on preferred dividend of **\$1.19M**  $(5*23.8\%)$  and
- on common dividend of **\$0.36M**  $((10 - 5 - 3.50)*23.8\%)$

**Total Tax Paid = \$5.05M**

**Net Return from \$100M Investment = \$4.95M**

➡ How does this example change after the TCJA? See <https://goo.gl/dMcWmw>

Source: JCX-45-16, Overview of Corp Debt & Equity



### [Sec. 385(a)]

(a) **AUTHORITY TO PRESCRIBE REGULATIONS.**—The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).

### [Sec. 385(b)]

(b) **FACTORS.**—The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

- (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
- (2) whether there is subordination to or preference over any indebtedness of the corporation,
- (3) the ratio of debt to equity of the corporation,
- (4) whether there is convertibility into the stock of the corporation, and
- (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.



### Notice 94-47

- Unconditional promise of issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future
- Holders possess the right to enforce the payment of principal and interest
- Holders's rights are subordinate to creditors's rights
- Holders's right to participate in the management of the issuer
- Issuer is thinly capitalized
- Identity between holders and stockholders
- Label placed upon the instruments by the parties
- Intent to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes

## C Corporations: Capital Structure

---

- Final Section 385 Regulations (May 2020)
  - Implement the authority to treat instrument as part debt and part stock
  - Debt instrument treated as stock:
    - Distribution of debt obligations to **related party**
    - Issuance of debt in exchange for **affiliate stock**
    - Debt issued pursuant to **internal asset reorganization**
    - Won't apply if immediately after issuance of the debt, the issue price of debt instruments held by expanded group <50mm

## C Corporations: Earnings Accumulation

---

- When is it beneficial for a C Corp to retain (and invest) its earnings rather than paying them out? Consider various combinations of the following parameters:
  - C Corp tax on earnings
  - SH tax on current and future distributions of earnings
  - SH tax on sale of shares
  - Investment opportunities of SHs and C Corps
  - See <https://goo.gl/dMcWmw>

### Accumulated Earnings Tax (AET)

- Applies to corporation formed or availed of for the purpose of avoiding tax by permitting E&Ps to be accumulated instead of being distributed. §532(a).
- If E&Ps accumulate “beyond the reasonable need of the business”, tax avoidance is presumed, unless corporation can prove to the contrary by a *preponderance of the evidence*. §533(a).
- 20% corporate tax on accumulated taxable income (ATI). §531.
  - $ATI = TI \text{ (with adjustments)} - \text{Dividends Paid} - \text{accumulated earnings credit (AEC)}$ 
    - Adjustments:
      - *Less:* taxes, unlimited charitable contributions, capital losses
      - *Plus:* NOLs, DRD. §535(a) and (b)
    - AEC: amount in excess of E&Ps retained for reasonable needs of business
    - Minimum Credit: \$250,000 (\$150,000 for service corporations). §535(c).

### Personal Holding Company (PHC) Tax

- 20% tax on undistributed person holding company income of PHC. §541
- PHC
  - 60% of AOGI is personal holding company income (PHCI); *and*
  - More than 50% of value of stock is owned by 5 or fewer individuals (with constructive ownership rules). §§542(a)(1) and (2); 544.
- PHCI
  - Dividends, interest, royalties, certain rents, certain computer software royalties, certain film rents, rent from the use of corporate property by certain shareholders, income from personal service contracts. §543.
  - Undistributed PHCI
    - TI minus dividends paid, taxes, charitable contributions
- Deduction for deficiency dividends. §547.
- When this provision was enacted, what do you think was the corporate-individual tax rate differential?