Chapter 16

Corporations: Introduction, Operating Rules, and Related Corporations

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Various Business Forms

- Sole proprietorships
- Partnerships
- S corporations
- Regular corporations (also called C corporations)

Sole Proprietorship

- Not a separate taxable entity
- Income reported on owner's Sch. C

Partnership

- Separate entity, but does not pay tax
- Allocates partnership income to partners
  - Partners report partnership income on personal tax returns
- Files information return (Form 1065)

S Corporation

- Separate entity, only pays special taxes (e.g.,built-in gains)
- Allocates entity income to shareholders
  – Shareholders report entity income on personal tax return
- Files information return (Form 1120S)

C Corporation

- Separate tax-paying entity
  - Reports income and expenses on Form 1120 (or Form 1120-A)
- Income taxed at corporate level and again at owner level when distributed as a dividend

Corporate Income Tax Rates

$50,000 or less	15%
Over $50,000 but not over $75,000	25%
Over $75,000 but not over $100,000	34%
Over $100,000 but not over $335,000	39%
Over $335,000 but not over $10,000,000	34%
Over $10,000,000 but not over $15,000,000	35%
Over $15,000,000 but not over $18,333,333	38%
Over $18,333,333	35%

Nontax Issues in Selecting Entity Form (slide 1 of 3)

- Liability
  - Sole proprietors and some partners have unlimited liability for claims against the entity
- Capital-raising
  - Corporations and partnerships to a lesser extent can raise large amounts of capital for entity ventures

Nontax Issues in Selecting Entity Form (slide 2 of 3)

- Transferability
  - Corporate stock is easily sold, but partners must approve partnership interest transfer
- Continuity of life
  - Corporations exist indefinitely

Nontax Issues in Selecting Entity Form (slide 3 of 3)

- Centralized management
  - Corporate actions are governed by a board of directors
  - Partnership operations may be conducted by each partner without approval by other partners

Limited Liability Companies (LLC)

- LLCs have proliferated since 1988 when IRS ruled it would treat LLCs as partnerships
  - Major nontax advantage
    - Allows entity to avoid unlimited liability
  - Major tax advantage
    - Allows qualifying business to be treated as a partnership for tax purposes, thereby avoiding double taxation associated with C corporations

Entity Classification Prior To 1997 (slide 1 of 2)

- Sometimes difficult to determine if entity will be taxed as a corporation
  - If entity has a majority of corporate characteristics, it is taxed as a corporation
  - Most entities have the following characteristics:
    - Associates
    - Objective to carry on business and share profits

Entity Classification Prior To 1997 (slide 2 of 2)

- If entity has a majority of the following relevant corporate characteristics it is treated as a corporation:
  - Continuity of life
  - Centralized management
  - Limited liability to owners
  - Free transferability of ownership interests

Entity Classification After 1996

(slide 1 of 2)

- Check-the-box Regulations
  - Allows taxpayer to choose tax status of entity without regard to corporate or noncorporate characteristics
  - Entities with > 1 owner can elect to be classified as partnership or corporation
  - Entities with only 1 owner can elect to be classified as sole proprietorship or as corporation

Entity Classification After 1996

(slide 2 of 2)

- Check-the-box Regulations (cont'd)
  - If no election is made, multi-owned entities treated as partnerships, single person businesses treated as sole proprietorships
  - Election is not available to:
    - Entities incorporated under state law, or
    - Entities required to be corporations under federal law (e.g., certain publicly traded partnerships)

Comparison of Corporate and Individual Tax Treatment (slide 1 of 2)

- Similarities
  - Gross Income of a corporation and individual are very similar
    - Includes compensation for services, income from trade or business, gains from property, interest, dividends, etc.
    - Corp taxpayers are allowed fewer exclusions
    - Nontaxable exchange treatment is similar
    - Depreciation recapture applies to both but corp may have additional recapture under §291

Comparison of Corporate and Individual Tax Treatment (slide 2 of 2)

- Dissimilarities
  - Different tax rates apply
  - All deductions of corp are business deductions
    - Corp does not calculate AGI
    - Corp does not deduct standard deduction, itemized deductions, or personal and dependency exemptions
    - Corp does not reduce casualty and theft loss by $100 statutory floor and 10% of AGI

Accounting Periods and Methods

(slide 1 of 2)

- Accounting periods
  - Most C corporations can use calendar year or fiscal year ending on last day of a calendar month (or 52-53 week year)
  - S corps and Personal Service Corporations (PSC) are limited in available year ends

Accounting Periods and Methods
(slide 2 of 2)

- Accounting methods
  - Cash method can't be used by C corp. unless:
    - In farming or timber business
    - Qualified PSC
    - "Ave. Annual Gross receipts" < = $5,000,000

Capital Gains and Losses

(slide 1 of 2)

- Individuals
  - Net capital gains subject to the following preferential tax treatment
    - Net short-term gains subject to regular tax rates
    - Net long-term gains max tax rate 20%
  - Net capital losses deductible up to $3,000 with remainder carried to future years

Capital Gains and Losses
(slide 2 of 2)

- Corporations
  - No special tax rates apply to capital gains
    - Entire gain is included in income subject to normal corporate tax rates
  - Corp cannot take a deduction for net capital losses
    - Capital losses can be used only to offset capital gains
    - Unused capital losses are carried back 3 years and carried forward for 5 years
      - Carried over losses are treated as short-term

Passive Losses

- Passive loss rules apply to:
  - Individuals and personal service corps
    - Cannot offset passive losses against active or portfolio income
  - S corps and partnerships
    - Passive income and loss flows through to owners and rules applied at owner level
  - Closely held C corps
    - May offset passive losses against active income, but not portfolio income

Charitable Contributions
(slide 1 of 5)

- Both corporate and noncorporate taxpayers may deduct charitable contributions in year paid
  - Exception for accrual basis corporations allows deduction in year preceding payment if:
    - Approved by board and
    - Paid within 2 1/2 months of year end

Charitable Contributions
(slide 2 of 5)

- Amount deductible for property contributions depends on type of property contributed
- Long-term capital gain property deduction = fair market value of property
  – Exception: Corp may only deduct basis if tangible personal property contributed and not used by charity in its exempt function

Charitable Contributions
(slide 3 of 5)

- Long-term capital gain property deduction = fair market value of property (cont'd)
  - Exception: Deduction for property contribution to certain private nonoperating foundations is limited to basis in property

Charitable Contributions
(slide 4 of 5)

- Ordinary income property deduction = basis in property
  - Exception: Basis plus 50 % of appreciation can be deducted if inventory or scientific property is contributed which is used by charity as required by Code

Charitable Contributions
(slide 5 of 5)

- Corporate charitable contribution deduction is limited to 10% of taxable income before:
  - Charitable contribution deduction,
  - NOL or capital loss carryback, and
  - Dividends received deduction
- Contributions in excess of 10% limit can be carried forward for 5 years

Net Operating Loss

- Net operating loss of corporation and individual may be:
  - Carried back two years
  - Unused portion carried forward 20 years

Dividends Received Deduction
(slide 1 of 2)

– If corporation owns stock in another corporation and receives dividends, a portion of dividends may be deducted from income:

% owned	Deduction Percent
Less than 20%	70%
≥ 20% but < 80%	80%
80% or more, and affiliated	100%

Dividends Received Deduction
(slide 2 of 2)

1. Multiply dividends received by deduction percentage
2. Multiply taxable income by deduction percentage
3. Subtract 1. from taxable income

   - If entity has income before DRD, but DRD creates NOL, amount in 1. is DRD

   -If DRD does not create NOL, deduction is limited to lesser of 1. or 2.

DRD Examples

Z Corp owns 60% of X Corp's stock in years 1, 2 & 3. Dividend of $200 is received each year. Limit (Step 1) is 80% x $200 = $160.

	1	2	3
Income	**400**	**301**	**299**
Dividend rec'd	**200**	**200**	**200**
Expenses	**(340)**	**(340)**	**(340)**
Income before DRD	**260**	**161**	**159**
80% of income	**208**	**129**	**127**

Year #1 $208 > $160, so $160 DRD

Year #2 $129 < $160, so $129 DRD

Year #3 DRD causes NOL ($159-$160), so $160 DRD is used.

$2 less income results in $31 more DRD.

Organizational Expenditures

- Corporation may elect to amortize organizational expenditures over period of 60 months or more
  - Costs of issuing or selling stock and transferring assets to the corporation reduce the amount of capital raised and are not deductible

Corporate Tax Formula

Gross income

Less: Deductions (except charitable, Div. Rec'd, NOL carryback, STCL carryback)

Taxable income for charitable limitation

Less: Charitable contributions (< = 10% of above)

Taxable income for div. rec'd deduction

Less: Dividends received deduction

Taxable income before carrybacks

Less: NOL carryback and STCL carryback

TAXABLE INCOME

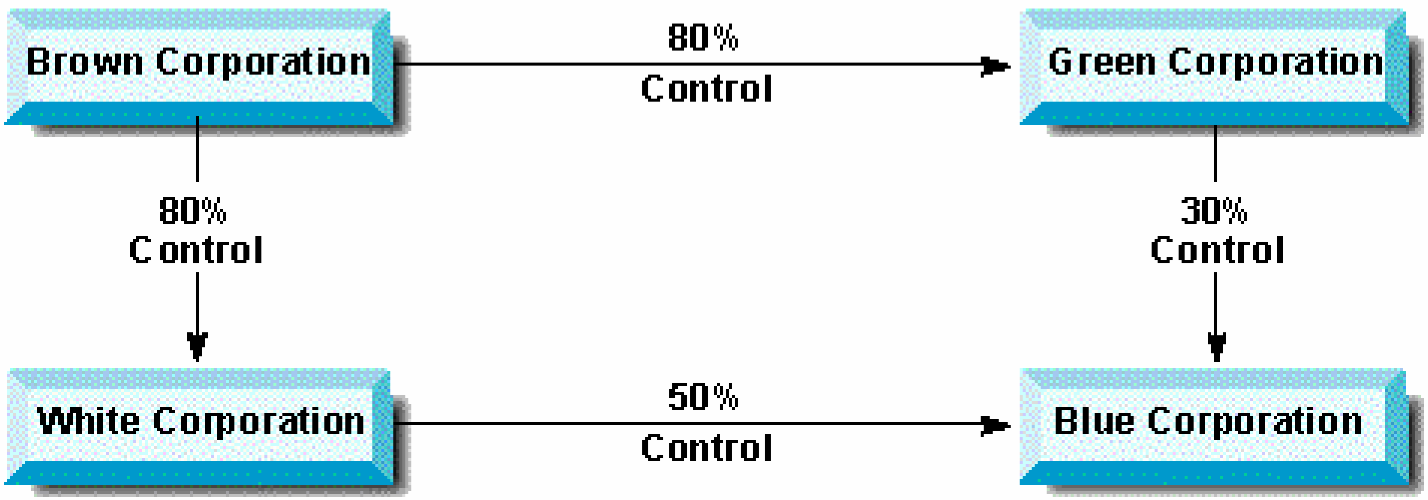
Tax Liability of Related Corporations

- Subject to special rules for computing income tax
  - Limits controlled group's taxable income in tax brackets below 35% to amount corporations in group would have if they were one corporation
- Controlled group includes:
  - Parent-subsidiary groups
  - Brother-sister groups
  - Combined groups

Parent-Subsidiary Controlled Group

- Consists of one or more chains of corporations connected through stock ownership with a common parent
  - Ownership is established through either:
    - Voting power test: requires ownership of stock with at least 80% of total voting power of all classes of stock entitled to vote
    - Value test: requires ownership of at least 80% of total value of all classes of stock

Parent-Subsidiary Controlled Group



Brown is the common parent of a parent-subsidiary controlled group consisting of Brown, Green, Blue, and White Corporations.*
*Reg. § 1.1563–1(a)(2).

Brother-Sister Controlled Group

- Exists if five or fewer persons meet an 80% and a 50% test:
  - 80% test: group owns 80% of vote or value of all classes of each corporation's stock
  - 50% test: smallest amount owned by each shareholder in one of the entities is determined
    - Amounts are summed for all shareholders and must be > 50%

Brother-Sister Group Example

	A	B	C	>50% test
Bob	60%	20%	20%	20%
Alice	20%	60%	20%	20%
Ted	20%	20%	60%	20%
>80% test	100%	100%	100%	

1. The group, combined, owns 100% of each entity's stock, so meets 80% test.
2. The lowest amount owned by Bob in any entity is 20%; same for Alice and Ted. Sum the 20% amounts for 60%. This is > 50% so 2nd test met.

Combined Groups

- Exist if all of the following conditions are met:
  - Each corp is member of either a parent-subsidiary or brother-sister controlled group,
  - At least one of the corps is parent of a parent-subsidiary controlled group,
  - Parent corp is also member of a brother-sister controlled group

Application of §482

- §482 permits IRS to reallocate income, deductions, and credits between two or more businesses owned or controlled by the same interests
- Used to prevent avoidance of taxes or to reflect income properly
  - Controlled groups of corps are especially vulnerable to §482

Consolidated Returns

- Members of a parent-subsidiary affiliated group may be able to file a consolidated income tax return

Corporate Filing Requirements
(slide 1 of 2)

- Must file Form 1120 (or Form 1120-A) on or before the 15th day of third month following close of tax year
  - Automatic 6 month extensions are available by filing Form 7004

Corporate Filing Requirements
(slide 2 of 2)

- Must make estimated tax payments equal to lesser of:
  - 100% of corporation's final tax, or
  - 100% of tax for preceding year
  - No estimated tax payments required if tax liability expected to be less than $500

Schedule M-1

- Corporations must reconcile financial accounting income with taxable income on Sch M-1, Form 1120
  - Common reconciling items include:
    - Federal tax liability
    - Net capital losses
    - Income reported for tax but not book income (e.g., prepaid income) and vice versa
    - Expenses deducted for book income but not tax (e.g., excess charitable contributions) and vice versa

Schedule M-2

- Corporations must reconcile retained earnings at beginning of year with retained earnings at end of year using Sch M-2, Form 1120

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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