CHAPTER 3-CORPORATE OPERATION

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3-1. There are many ways a "profitable" U.S. corporation may pay no taxes in the United States. For example, a U.S. corporation that earns all its income from activities outside the United States may be able to offset its U.S. tax liability with foreign tax credits. A profitable U.S. corporation also may have net operating loss carryovers that reduce taxable income to zero. In some cases, a corporation that is profitable in an economic sense may report little taxable income because of various artificial tax incentives such as accelerated depreciation, the receipt of tax-exempt interest, the use of the installment method to report gain, or the dividends-received-deduction, or they may pay little tax because of credits like low income housing credits.

3-2. The purpose of this problem is to illustrate the relationship between the AMT and the regular tax. Because the application of the AMT in year 1 deprives X Corp. of the deferral benefits of the completed contract method under the regular tax, X Corp. would be doubly penalized if in year 2 it has a big gain on the completed contract method. To remedy this problem, §53 permits a credit against the regular tax for an AMT liability of a prior year resulting from deferral preferences. Although X Corp.'s overall tax may be the same with or without the AMT, the AMT may accelerate the payment of tax.

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3-3. This problem focuses on the debt/equity distinction. If the notes are respected as debt, the interest will be deductible. If the instruments are classified as stock for tax purposes, X Corp. will get no deduction. Based on the facts given, the Service has taken the position that the instruments will be treated as stock for tax purposes.

The instruments do not represent a promise to pay a sum certain because of the high probability of conversion into stock. At maturity, the holder of the instrument will elect to receive the stock (presently worth $1,000) rather than the $600 cash unless the stock drops in price by more than 40 percent. Furthermore, as long as the 50 shares of X Corp. stock trade for more than $600 in the aggregate ($12 per share), shareholders will never let X Corp. redeem the instruments for $600. In effect, X Corp. can force conversion at any time after two years from issuance. Moreover, it may be in X Corp.'s interest to force the conversion since by doing so it can avoid paying out cash. A redemption of the instruments with a $1000 issue price for $600 of cash will cause X Corp. to recognize the $400 difference as ordinary income. See §61(a)(12) and Treas. Regs. §1.61-12(c)(2)(ii). Since it is unlikely that the instrument holders will receive $600 in cash, there is no promise to pay a sum certain.

Other factors that support stock classification include: depending on the prevailing interest rate, the guaranteed annual return of $60 on the $1,000 investment may be low compared with comparable noncontingent instruments; more than 65 percent of the future annual yield may be discretionary based on the level of discretionary dividends paid on X Corp. common stock; the instruments are subordinated to X Corp.'s general creditors.

3-4. This problem illustrates another aspect of the debt/equity problem. Normally, even if a financial instrument is mischaracterized as debt, the interest deduction will be offset with an interest inclusion. Understandably, the fisc would benefit more if the corporation making the periodic return were denied a deduction while the recipient still included the dividend received. While normally an interest deduction is offset with an interest inclusion, that may not be the case if the recipient is a nonresident that is not subject to U.S. taxation on the interest income. For example, Y Corp. may not be subject to U.S. taxation on the interest payment because of the treaty between the Netherlands and the United States. From the U.S. perspective, the combination of a deduction by X Corp. and no inclusion by Y Corp. strips the United States of the ability to tax the earnings of X Corp. used to make the interest payment. In response to this perceived problem, Congress has enacted §163(j), the earnings stripping provision, which denies an interest deduction to X Corp. in some situations where interest is paid to a related party and the payor is deemed to be thinly capitalized.