

6 Chapter 6 – Corporations: Formation, Operation, Capital Structure, and Liquidation: This chapter is concerned exclusively with entities taxable as C corporations. Under the traditional US tax regime, corporate profits are taxed when earned by the operating corporation and a second time when distributed to shareholders. Starting in 2003, almost all dividends of US corporations have been taxed at the long-term capital gains rate (currently 20%) when distributed to shareholders; prior to 2003, dividends were subject to taxation as ordinary income.

6.1 Corporate Formation: Under section 351, the formation of a corporation is tax-free to the contributing shareholders and to the corporation. However, if a shareholder receives other property (“boot”) in addition to the corporation’s stock, then gain on the transaction must be recognized equal to the *lesser* of the gain realized on the exchange and the value of the boot received. Consistent with this generally tax-free treatment, the contributing shareholder takes a substituted basis in the stock received (that is, the adjusted basis of the property contributed) while the corporation takes a carryover basis in the assets themselves. These basis rules ensure that pre-contribution unrealized appreciation in the contributed assets will be recognized both to the corporation (when the assets are sold) and to the shareholder (when the stock is sold). Note that contribution of low-basis property imposes a tacit tax cost on the corporation, so that if one shareholder contributes high-basis property while another contributes low-basis property, the shareholders should be careful to take into account the potential corporate-level taxes when determining the value that should be contributed by each shareholder.

6.1.1 A Quick Note on “Basis”: If a taxpayer purchases an asset for \$100 and sells it for \$130, the taxpayer’s gain equals \$30. The value received is called the “amount realized” by the taxpayer and the taxpayer’s cost is called the taxpayer’s “adjusted basis” (usually shortened to “basis”). For assets that are purchased, basis equals cost. For assets acquired by gift, the donee’s basis

is set equal to the donor's basis at the time of transfer (i.e., a carryover basis transaction). For property acquired from the estate of a decedent, basis equals the fair market value of the asset as of the date of the decedent's death. Basis can be adjusted for a variety of events including post-acquisition investment and post-acquisition depreciation. For example, if a taxpayer purchases rental property for \$100,000, the taxpayer's cost basis equals \$100,000. If the taxpayer then invests an additional \$20,000 in new flooring and other improvements, the taxpayer's basis increases by \$20,000 to \$120,000. If the taxpayer is then entitled to claim depreciation of \$15,000 (that is, the taxpayer is entitled to deduct \$15,000 of her investment against current income), then the taxpayer's basis is reduced by the \$15,000 to \$105,000 (i.e., once basis provides a tax benefit, it is lost and so cannot be used a second time).

- 6.1.2 Note that when low-basis property is contributed to a corporation under §351, the corporation receives both a valuable asset and a built-in tax liability. Because that tax liability ultimately will be paid by the corporation, it reduces the value of all outstanding shares of common stock. Thus, some of the cost of the built-in tax liability will be borne by shareholders other than the shareholder who contributed the low-basis property. Depending on when the corporation is likely to incur that tax liability, the shareholders should negotiate a way to ensure the liability is in effect shifted to the contributing shareholder.
- 6.1.3 This same problem can arise when a divorcing couple divides a valuable asset by borrowing against the asset and then gives the proceeds to one member of the marital community and the encumbered asset to the other: the party getting cash faces no built-in tax liability while the party getting the

encumbered asset may be facing a significant tax liability in the future if the asset has a low basis.

6.1.4 If property with a built-in loss (i.e., property with basis in excess of fair market value) is contributed to a corporation in exchange for stock (or stock and boot), no loss is recognized and the corporation takes a basis in the property equal to its current fair market value while the shareholder takes a basis in the stock equal to her adjusted basis in the transferred property. In this way the loss is not doubled but only preserved in the hands of the shareholder. However, the shareholder may make an election to reverse these rules so that the loss is preserved inside the corporation (that is, the corporation takes the shareholder's high basis in the asset) but the loss is not duplicated in the hands of the shareholder (that is, the shareholder's basis in the stock equals the fair market value of the property). Note that if such an election is made, the value of the loss is shifted from the shareholder to the corporation and so indirectly in part to the other shareholders.

6.1.4.1 Because stock is a capital asset, retaining the loss by the shareholder will eventually generate a capital loss that may not be useful. But if the property that is transferred is inventory, it will generate an ordinary loss to the corporation. Of course, the shareholder might be able to sell the property and then incorporate the cash.

6.1.4.2 If the shareholder holds the stock for a long time, the loss will be deferred. But if the asset is sold (or depreciated) by the corporation quickly, the tax benefit of the high basis will be enjoyed much earlier.

6.1.4.3 If the corporation is closely held, shifting the loss to the corporation and through it to the shareholder's family may be a way to avoid the estate and gift taxes: payment of additional tax by the shareholder reduces the shareholder's estate, and recognition of the loss by

the corporation makes the corporation more valuable for all of its owners.

## 6.2 Taxation of Corporate Operations

### 6.2.1 Book- Tax Differences: Taxable Income versus GAAP Income.

The goal of GAAP is to provide accurate information for equity and debt investors; the goals of the tax laws are different and more diverse. When transactions have different tax and GAAP treatments, we say that the difference is a book-tax difference.

### 6.2.2 Net Operating Losses: If a corporation has negative taxable income, it has a *net operating loss*. Under current law, an NOL is a deduction against ordinary income that can be carried forward indefinitely.

### 6.2.3 Gains and Losses and Basis: Gains and losses are computed by comparing amount realized with adjusted basis.

### 6.2.4 Capital Gains and Losses: Unlike individuals, corporations do not enjoy a preferential tax rate on net long-term capital gain. Nevertheless, net capital losses are subject to a significant disability: net capital losses cannot be claimed in the current taxable year but can be carried back 3 years and forward 5 years to offset net capital gain in those years. Thus, corporate capital losses can only offset capital gain, and there is no distinction between long-term and short-term gains and losses.

### 6.2.5 Section 1231 Assets: Section 1231 assets include depreciable property and real estate used by the corporation in its trade or business so long as the asset has been held by more than 1 year. Net section 1231 gains are reported as capital gain (and so can be offset by capital loss) and net section 1231 losses are reported as ordinary losses (and so can offset ordinary income).

### 6.2.6 Dividends Received Deduction: A corporation that *receives* a dividend is entitled to a dividends-received deduction (“DRD”) equal to 50%, 65%, or 100% of the dividend received. If the

recipient owns less than 20% of the distributing corporation, the DRD equals 50%; if it owns between 20% and 79.9%, the DRD equals 65%; if the ownership is 80% or more, the DRD equals 100%. Using a 21% tax rate, the effective tax rate on a dividend subject to a 50% DRD is 10.5%; at an 65% DRD, the effective tax rate is 7.35%.

#### 6.2.7 Consolidated Tax Returns:

6.2.7.1 Overview: Only domestic corporations can be combined into a consolidated group. To have a consolidated group, there must be one corporation (the group “Parent”) that directly owns at least 80% of a second corporation (a “subsidiary”). Once that is established, all domestic corporations owned at least 80% by members of the group are in the group (insurance companies, exempt organizations, and S corporations cannot be members of a consolidated group). To form a consolidated group, all members of the group must consent to the election. Once the election is made, subsequent affiliated corporations automatically are included in the group.

6.2.7.2 Deconsolidation: There can be times when a consolidated group would like to deconsolidate one or more of the subsidiary corporations without eliminating the consolidated group as a whole and without transferring any ownership of the subsidiary to an unrelated owner. While no formal election makes this possible, it is simple to achieve: have the group form a partnership and then have all of the shares of the subsidiary transferred in the partnership. This deconsolidates the subsidiary because it is not (formally) owned by the group (it is owned by the partnership, and a partnership cannot be part of an affiliated group of corporations).

- 6.3 Possible Tax Benefit of Leverage in Firms' Capital Structures
- 6.3.1 Theory of the Tax Benefits of Leverage: In a perfect market, all investments generate the same, risk-adjusted return. Accordingly, a corporation's capital structure should not affect its worth although it can affect its risk level. In general, the corporate plus shareholder level taxes on corporate debt investments are lower than on equity investment. As a result, one would expect that corporate debt investment will be preferred until the amount of debt is sufficient to lower the tax rate of the corporation to cause the value of the interest deduction to diminish significantly. Note that if a corporation has other tax-preferred positions, then a lower level of debt will be preferred.
- 6.3.2 Empirical Work on the Tax Benefits of Leverage: No one knows anything.
- 6.4 Debt-Equity Hybrids: Common stock and straight debt represent the two ends of an investment spectrum, with each point representing some right to share in the profits of the venture (fixed share or unlimited, preferred or residual). Despite this being a continuous spectrum, US tax law generally insists on a binary classification: debt or equity. However, even as to instruments classified as debt, the interest paid deduction can be limited. See, e.g., §163(j).
- 6.4.1 Traditional Preferred Stock: Traditional preferred stock has a limited interest in the profits of the venture (much like debt) but is not promised any guaranteed return absent profits (unlike debt). Usually, dividends cannot be paid on common stock if dividends on preferred stock are in arrears, and usually (though not always) the dividend right on preferred stock is cumulative so that a dividend missed in one period must be paid in a subsequent period prior to any return to common equity.
- 6.4.2 Trust Preferred Stock: Trust preferred stock is a transaction using a wholly-owned subsidiary to transform interest

payments into dividends. Looking at **figure 6.1** on page 6-10, where Texaco borrows \$350 million from its wholly-owned subsidiary, a subsidiary that acquired that \$350 million by issuing preferred stock paying the same return. Nationally regulated banks like this structure because it offers regulatory advantages.

6.4.2.1 Tax Treatment of Trust Preferred Stock: Texaco can deduct the interest paid, interest that is taxable to the subsidiary. The preferred stock issued by the subsidiary is classified as debt for US tax purposes, so the subsidiary's net income is zero. The investors must report interest income (taxable at ordinary income rates) as they received distributions on the trust preferred shares. The same result could be obtained by having Texaco issue debt directly, but until 2003 this structure allowed Texaco to move the debt off its balance sheet into a separate line item.

6.4.2.2 Financial Reporting of Trust Preferred Stock: Since 2003, trust preferred stock must be treated as debt on Texaco's balance sheet.

6.4.2.3 Regulatory Treatment of Trust Preferred Stock: Despite the classification of trust preferred stock as debt for tax and GAAP purposes, the Federal Reserve generally permits trust preferred stock to be treated as an equity investment for determining a bank's required capital cushion.

6.4.2.4 The Lesson of Trust Preferred Stock: When different regimes (tax, GAAP, Federal Reserve System) treat transactions differently, there often will be a way to exploit the inconsistencies.

6.4.3 Zero-Coupon Bonds: Zero-coupon bonds replace periodic explicit interest with implicit interest equal to the excess of redemption price over issue price.

6.4.3.1 Example of Taxation of Zero-Coupon Bonds: See **table 6.1** (p. 6-13) for an example.

6.4.3.2 Is a zero-coupon bond more or less sensitive to interest rate fluctuations in the market as compared with a bond paying interest explicitly (in the form of interest rate coupons or the equivalent)? More: the implicit interest from a zero-coupon bond tacitly is reinvested in the bond itself. But for a bond that pays explicit interest, the interest payments received by the holder can be invested at the current market interest rate, thereby hedging against interest rate fluctuations.

6.4.4 A different kind of hybrid instrument is “tracking stock.”

Tracking stock is stock whose return is tied to a subset of the assets of the issuing corporation. It was first used in a transaction structured by Martin Ginsburg. For example, Dell Corporation acquired EMC, a data storage company. Most of the assets of EMC were rolled into Dell, but one former EMC subsidiary, VMware, remained as a separate subsidiary of Dell. Dell issued new company stock that tracked the economic performance of VMware. This allowed Dell to tap the investor market based on the value of VMware even if such investors were not interested in investing in Dell stock.

6.5 Taxation of Distributions and Share Repurchases: A “distribution” is a transfer of value from a corporation to a shareholder in her capacity as shareholder. A “redemption” is a distribution in exchange for stock of the distributing corporation. A “dividend” is a distribution out of the corporation’s earnings and profits, generally taxable to an individual at 20%. A distribution in excess of earnings and profits is treated as a return of the shareholder’s investment in the shares. To the extent a distribution exceeds the earnings and profits account and exceeds the shareholder’s adjusted basis in the shares, it is taxable as capital gain.

- 6.5.1 The Concept of Earnings and Profits: Earnings and profits of a corporation roughly equal its retained earnings. Note, though, that exempt income adds to the e&p account while nondeductible federal income taxes reduce e&p.
- 6.5.2 Special Kinds of Distributions: Corporate distributions can be made in property as well as in cash. If the property is appreciated, the corporation is taxed as if the corporation sold the property to the shareholder, but if the property has unrealized loss, the loss is disallowed.
- 6.5.3 Taxation of Share Repurchases: In many circumstances, a share repurchase is taxed to the shareholder as a sale or exchange rather than as a distribution. To the corporation, it is treated as a distribution.
- 6.6 Tax Planning Using the Tax Rules for Distributions and Share Repurchases: *Individual shareholders* generally prefer sale or exchange treatment to distribution treatment: although the tax rates are the same, sale or exchange treatment permits a recovery of basis prior to recognition of income. *Corporate shareholders* generally prefer distribution treatment (assuming the distributing corporation has e&p) because of the DRD.
- 6.7 Taxation of Liquidations: A liquidating corporation (other than in a parent-subsidary liquidation) recognizes all unrealized gain (and, generally, all unrealized loss) on its liquidating distribution. The shareholders treat the distribution as in exchange for their shares. Earnings and profits are irrelevant.
  - 6.7.1 Parent-Subsidiary Liquidations: If a subsidiary corporation liquidates while at least 80% of its stock is owned by a parent corporation, the transaction generally is tax-free to both corporations and the distributed assets retain their adjusted bases in the hands of the parent corporation.
- 6.8 Discussion Questions (p. 20)
  - 6.8.1 Question 2: The dividends-received deduction allows corporate recipients of dividends to be only partially taxable

on those dividends. The idea is to mitigate having corporate income be subject to more than double taxation. If the dividends received deduction did not exist, consider how many layers of tax would be paid on corporation A's earnings that are paid out in a dividend to corporation B and finally to corporation B's individual shareholders. There would be a potential for three layers of taxation.

6.8.2 Question 9: Individuals shareholders prefer a share repurchase to be treated as a sale or exchange because (1) they are only taxed to the extent their proceeds from the repurchase exceed their tax basis in the stock sold and (2) they have the potential to be taxed at low long term capital gains rates (which during some time periods have been below dividend tax rates). Corporate shareholders typically prefer a share repurchase to be treated as a dividend because the dividends received deduction allows corporations to be taxable on only a portion of the dividend income, and under current law corporations are taxed at the same rate on long term capital gains as they are on ordinary income.

## 6.9 Exercises (p. 20)

### 6.9.1 Exercise 13:

6.9.1.1 Part (a): \$25,000 of dividend income. No change in stock basis.

6.9.1.2 Part (b): \$2,500 of dividend income. Stock basis reduced by \$22,500 to \$17,500. (Current e&p equals \$10,000; your client received one-quarter of the distribution so is allocated one-quarter of the e&p.)

6.9.2 Exercise 14: Because DMM does not own at least 80% of either subsidiary, there cannot be a consolidated group. As a result, the subsidiaries' operating losses do not affect DMM's taxes.

6.9.3 Exercise 16: Brad: \$100,000; Scott: \$450,000; Jake: \$100,000.