



Dbriefs U presents:

# Taxation of Subchapter C Corporations — Beyond the tax return

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# Agenda

- What is a C corporation?
- Differences between the taxation of a C corporation and an individual
- The life cycle of a C corporation
- Corporate tax planning strategies

# What is a C corporation?

A C corporation is an entity created under state law and treated as an entity apart from its owners for purpose of legal liability.

- Formed through a state incorporation statute
- Number of shareholders may vary; corporation may be closely held, widely held, and publicly held
- Stockholders generally elect board of directors
- Board of directors manage the corporation through officers responsible for day to day operations
- Subject to income tax separate from its stockholders
- Profits subject to a second level of tax at stockholder level when distributed

# C corporation vs. individual

	<b>C corporation</b>	<b>Individual</b>
Tax year	Calendar or fiscal year	Calendar year (generally)
Tax form	1120	1040
Method of accounting	Accrual (generally)	Cash
Taxes imposed	<ul style="list-style-type: none"> <li>• Profits taxed at corporate level</li> <li>• Distributions taxed at individual level</li> </ul>	<ul style="list-style-type: none"> <li>• Income taxed once upon receipt or constructive receipt by individual</li> </ul>
Tax rates*	<ul style="list-style-type: none"> <li>• Business income: Progressive, 35% top rate</li> <li>• Capital gains: Progressive, 35% top rate</li> <li>• Dividends: Progressive, 35% top rate (although certain exemptions apply)</li> <li>• Alternative minimum tax: 20%</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable income: Progressive, 35% top rate</li> <li>• Long term capital gains: 15%</li> <li>• Qualified dividends: 15%</li> <li>• Alternative minimum tax: 26–28%</li> </ul>
Consolidated vs. separate	<ul style="list-style-type: none"> <li>• May file separately or elect to file consolidated with affiliated group of corporations</li> </ul>	<ul style="list-style-type: none"> <li>• May file separately or jointly as husband and wife</li> </ul>

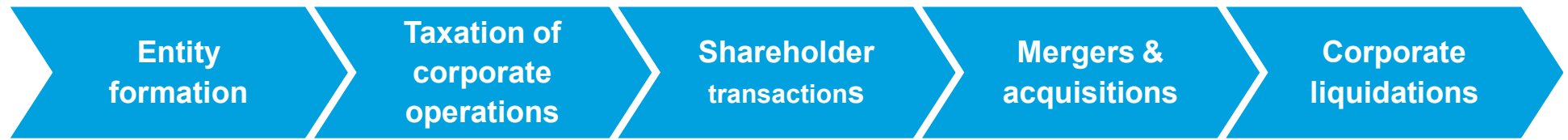
\*Individual tax rates applicable for 2010

# C corporation vs. individual (cont.)

	C corporation	Individual
Loss carryover	<ul style="list-style-type: none"> <li>• Ordinary loss: Back 2 years, forward 20 years</li> <li>• Capital loss: Back 3 years, forward 5 years (generally)</li> </ul>	<ul style="list-style-type: none"> <li>• Business loss: Back 2 years, forward 20 years</li> <li>• Capital loss: Forward indefinitely (may use \$3K to offset ordinary income in any year)</li> <li>• Personal deductions cannot create a loss carryover</li> </ul>
Deductions (generally)	<ul style="list-style-type: none"> <li>• All ordinary and necessary expenses incurred to carry on the business</li> </ul>	<ul style="list-style-type: none"> <li>• Above the line deductions (i.e., student loan interest, moving expenses, traditional IRA contributions)</li> <li>• Standard deduction or itemized deductions</li> </ul>
Interest expense	<ul style="list-style-type: none"> <li>• Deductible, but subject to certain limitations</li> </ul>	<ul style="list-style-type: none"> <li>• Mortgage interest deductible, subject to limitations</li> <li>• Investment interest deductible to the extent of investment income</li> <li>• Other “personal” interest not deductible</li> </ul>
Exemptions	<ul style="list-style-type: none"> <li>• None</li> </ul>	<ul style="list-style-type: none"> <li>• Personal exemption for taxpayers and qualifying dependants</li> </ul>

# Life cycle of a C corporation

## Overview

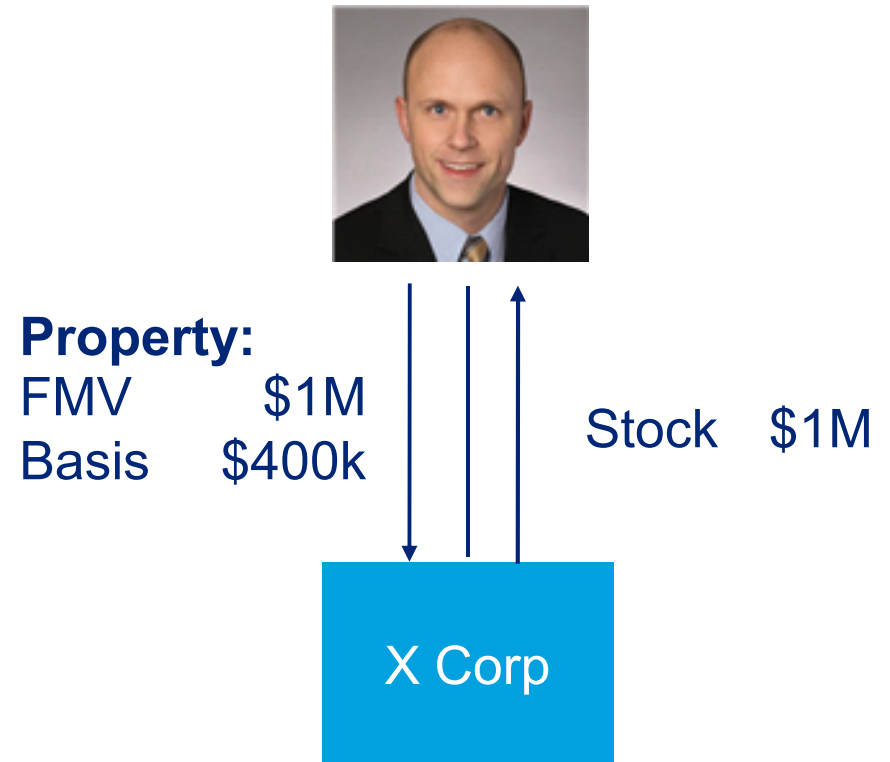


# Life cycle of a C corporation

## Entity formation

### Section 351 transfers

- Generally, section 351 transfers are tax free
- Requirements
  - Property is transferred to a corporation;
  - The transfer is solely in exchange for stock of the corporation;
  - The transferors “control” the corporation immediately after the exchange; and
  - The corporation is not an investment company



# Life cycle of a C corporation

## Entity formation (cont.)

- **Property** — Includes real and personal property, tangible and intangible property, and money
- **Solely in exchange for stock** — Stock generally includes common, preferred, voting and nonvoting stock, and other instruments that provide the holder with an equity interest in the corporation
  - Excludes stock rights, warrants, options, and convertible bonds
  - Receipt of money or property by the shareholder is permitted, but generally causes the shareholder to recognize gain to the extent of the FMV of property received (i.e., the lesser of (1) the realized gain on the property transferred, or (2) the amount of property received)
    - A realized loss is not recognized

# Life cycle of a C corporation

## Entity formation (cont.)

Section 351 — Example with boot



### Property:

FMV \$1M  
Basis \$400k

Stock \$700k  
Cash \$200k  
Other FMV \$100k



Wolfe's realized gain = \$600k

Boot received = \$300k

Wolfe's recognized gain = \$300k  
(amount of realized gain not to exceed boot)

# Life cycle of a C corporation

## Entity formation (cont.)

- **Control** — Transferor(s) must obtain ownership of at least 80% of the total voting power of all classes of stock and 80% of the total number of each other (i.e., non-voting) classes stock
- **Shareholder basis in stock** — Generally, shareholder obtains a basis in the stock that is based upon the shareholder's basis in the property transferred, plus any gain recognized
- **Corporation's basis in property received** — Generally, a corporation's basis in the assets received in a section 351 transfer is the same as the basis of the property in the hands of the transferor (i.e., shareholder)
  - Subject to limitation on loss property

# Life cycle of a C corporation

## Taxation of corporate operations

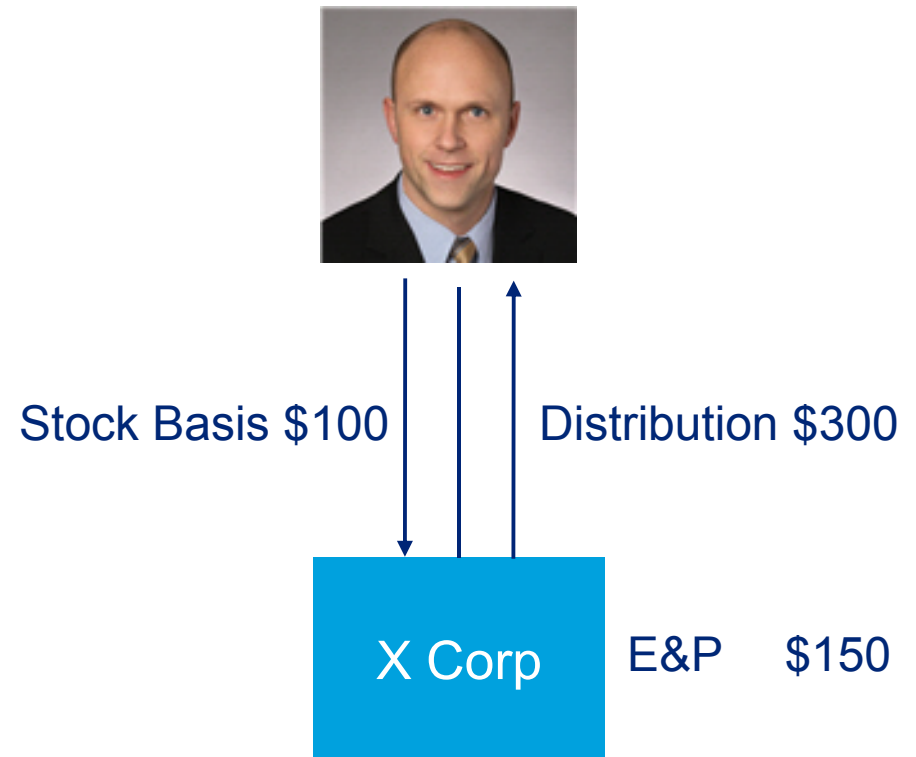
- A corporation's taxable income is taxed at graduated rates when less than \$10M
  - If taxable income is greater than \$10M, tax rate is a flat 35%
- A corporation's taxable income is the corporation's gross income less ordinary and necessary business expenses and interest expense, and other allowable deductions
- Common disallowed expenses include:
  - 50% of certain meals and entertainment expenses
  - Fines and penalties imposed by a federal, state, or local government for the violation of any law
  - Premiums paid on any life insurance policy if the corporation is directly or indirectly a beneficiary

# Life cycle of a C corporation

## Shareholder transactions

### Distributions: Section 301

- Transfer of property by a corporation to its shareholders
  - Amount of distribution equals FMV of money or other property received
- Ordering rules for determining treatment of a distribution
  - Dividend to the extent of E&P
  - Nontaxable return of capital (i.e., reduce stock basis)
  - Excess is gain from the sale or exchange of the underlying stock

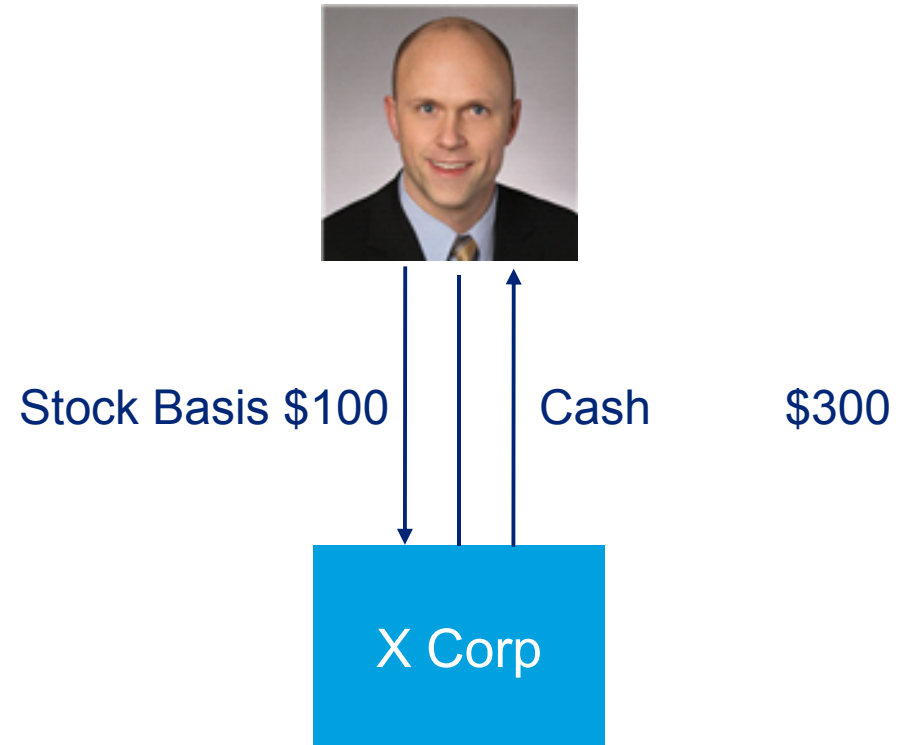


# Life cycle of a C corporation

## Shareholder transactions (cont.)

### Redemptions: Section 302

- Acquisition by a corporation of its own stock from a shareholder in exchange for money or property
- Redemptions may be characterized as either:
  - (1) a sale of the stock by the shareholder to the corporation, or
  - (2) a distribution
- Tax rules provide tests to determine sale or distribution treatment



# Life cycle of a C corporation

## Shareholder transactions (cont.)

### Redemptions: Section 302 (cont.)

- Tests for determining sale treatment (must meet one):
  - “Not essentially equivalent to a dividend”
    - “Meaningful reduction” in the shareholder's “incidences of ownership” in the corporation
  - “Substantially disproportionate redemption of stock”
    - Immediately after the redemption:
      - Shareholder owns less than 50% of total combined voting power of all voting classes of stock; and
      - Shareholder owns less than 80% of the percentage of voting stock owned by the shareholder before the redemption;
  - Complete termination of interest
  - Partial liquidation

# Life cycle of a C corporation

## Mergers and acquisitions

### Reorganizations

- Stock
- Asset

### Acquisitions and dispositions

- Stock
- Assets
- Hybrid (e.g., section 338 election)

# Life cycle of a C corporation

## Corporate liquidations

### Taxable liquidations

- Section 331 taxable liquidations (general rule)
  - Taxable exchange for shareholder — treated as sale of stock for the value of the assets received
    - Gain or loss recognized — money plus FMV of property received, less liabilities assumed, less adjusted stock basis
  - Taxable exchange for corporation — treated as sale of distributed property by corporation for FMV
    - Gain or loss recognized — FMV less adjusted tax basis of assets distributed
      - FMV of property can not be less than liabilities assumed by shareholder

# Life cycle of a C corporation

## Corporate liquidations (cont.)

### Tax free liquidations

- Section 332 tax free subsidiary liquidations (exception)
  - Tax free if the following requirements of 332 are met:
    - Recipient corporation must own at least 80% of the vote and value of liquidating corporation;
    - Distribution is in complete cancellation or redemption of all of the liquidating corporation's stock; and
    - Transfer occurs within the taxable year
  - Section 332 is not elective
  - No loss recognized by liquidating corporation
  - Not applicable to distributions to minority shareholders (non-80% owner)

# Corporate tax planning strategies

## Installment sales

- Deferring revenue associated with certain sales contracts

## Advance payments deferral

- Deferring income related to advance payments

## Section 199 domestic manufacturer's deduction

- 9% of qualified production activities income

## Recurring item exception

- Using the recurring item exception to accelerate the recognition of certain expenses

## Disputed income

- Exclude disputed amounts from taxable income in the tax year the sales transaction occurred since there is not a "fixed right" to receive the income

# Corporate tax planning strategies (cont.)

## Bad debt

- Recognition of a bad debt deduction in the year the debt becomes wholly worthless

## Accrued bonus payments

- Deduct bonus accruals in the year the liability is fixed and determinable as long as payment is made within 2½ months after year-end

## Cap to expense (repair costs)

- Expenditures are deductible in the tax year incurred as incidental repairs if they do not prolong the useful life, alter the use, or increase the value of the property

## Prepaid expenses

- Deduct certain prepaid expenses (such as payment liabilities like insurance) for the tax year of prepayment if the underlying coverage period is 12 months or less

# Key takeaways

- Taxation of C corporations is an exciting and dynamic area of practice
- There are key differences between how C corporations are treated versus individuals
- Formation of a C corporation can be accomplished tax-free
- There are important distinctions between distributions or redemptions, and the tax consequences associated with each
- A liquidation is NOT a party with an open bar

# Poll question #1

The State of Delaware is generally regarded as the easiest state to register and form a corporation, with well written statutes and widely studied rules and regulations.

Approximately, how many corporations were formed in Delaware in 2009?

- 1,000
- 5,000
- 20,000
- 35,000

## Poll question #2

The maximum federal corporate tax rate currently is:

- 50% — The U.S. recently followed the United Kingdom's lead
- 35% — At least for the moment
- 15% — The U.S. has followed the international trend to lower corporate tax rates
- Depends upon the state of incorporation

# Poll question #3

What is a corporate liquidation?

- Nickname for a liquid similar to Brangelina for Brad and Angelina
- The distribution by a corporation of all of its assets and liabilities to its shareholders
- Being completely drenched by liquid (i.e., being sprayed with a hose)
- A party with an open bar

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