

CHAPTER 2
CORPORATIONS: INTRODUCTION AND
OPERATING RULES

LECTURE NOTES

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2013 Edition. For major changes, see the Preface to the Instructor's Edition of the text.

News Boxes

- Added Tax in the News titled *LLC's Pseudo Corporate Status Not Recognized for State Transfer Taxes*.
- Added Tax in the News titled *Too Much of a Good Thing?*
- Added Tax in the News titled *Presidential Campaign Highlights Call for Corporate Tax Reform*.
- Removed Tax in the News titled *The President's Economic Recovery Advisory Board Offers Options for Corporate Tax Reform*.
- Removed Tax in the News titled *Not All Corporations Are Created Equal*.

Ethical and Equity Considerations

- Added Ethics and Equity titled *Best of Both Worlds?*
- Removed Ethics and Equity titled *Art Is in the Eye of the Beholder!*

Global Tax Issues

- Updated Global Tax Issues titled *U.S. Corporate Tax Rate and Global Competitiveness*.

2.1 TAX TREATMENT OF VARIOUS BUSINESS FORMS

1. Business forms include: sole proprietorships, partnerships (covered in Chapters 10 and 11), trusts and estates (covered in Chapter 20), Subchapter S corporations (covered in Chapter 12), and regular Subchapter C corporations.
2. C corporations are separate taxable entities, compute their own taxable income, and pay their own taxes.

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Sole Proprietorship

3. Sole proprietorship is not a taxable entity. Net income or loss from the proprietorship is computed on Schedule C, which is attached to the proprietor's Form 1040. Thus, the proprietor pays tax on the profits of the proprietorship.

Partnerships

4. Partnerships, which are not taxable entities, must file Form 1065 (an information return). Each partner receives a Schedule K-1 that reports the partner's share of ordinary business income (loss) along with each separately reported pass-through item. Schedule K-1 items are reported on each partner's return.

Corporations

5. There are two types of corporations: regular corporations governed by Subchapter C and nontaxable corporations governed by Subchapter S. S corporations have the following characteristics.
 - Similar to partnerships with respect to tax treatment because both are not taxable entities, but are reporting entities (Form 1120S).
 - Income and expense items pass through to shareholders, who report the items on their own returns.
 - Generally enjoy the same legal benefits (e.g., limited liability) as C corporations.
6. Many items, such as capital gains and losses, retain their character when passed through to the owners of proprietorships, partnerships, and S corporations.
7. Regular C corporations are subject to double taxation effects.
 - a. Closely held corporations may attempt to avoid the double taxation by making deductible payments to their shareholders (e.g., salaries, interest, or rents) that are large enough to reduce corporate taxable income to zero.
 - b. Reduction of the dividend tax rate to a maximum of 15% or 20% (0% for low-income taxpayers) alleviates some of the double taxation effect.
 - (1) Shareholders prefer dividends rather than salary or interest because of the lower tax rate dividends receive.
 - (2) Corporations prefer payments that are deductible in computing their taxable income. However, dividends do reduce the possible accumulated earning tax, unreasonable compensation, and thin capitalization problems with the IRS.
8. The choice of entity should be based on a combination of tax and nontax factors.
 - a. Tax Factors. The top corporate rate is 35% (39% on a limited range of taxable income), while the top rate for individuals is 39.6%. However, for a specified level of income the corporate or individual tax rate can be higher because their tax rate schedules are different.

- (1) Tax rate of dividends should also be considered. Beginning in 2013, the effective tax rate on dividend (and net capital gain) income increases for high-income taxpayers as a result of the 3.8% Medicare surtax on net investment income in excess of modified adjusted gross income of \$200,000 (\$250,000 if married filing jointly).
 - (2) With pass-through entities, items of income, gains, deductions, and losses retain their character for the owner. C corporation items do not pass through.
- b. Nontax Considerations. Nontax considerations may override tax considerations. Those considerations favoring the corporate form include the following.
- Limited liability.
 - Ability to raise large amounts of capital.
 - Continuity of life for the entity.
 - Free transferability of ownership interests.
 - Centralized management.
- c. The majority of businesses in the U.S. are small pass-through entities. For a recent Congressional Research Service analysis of IRS data on U.S. business tax reporting, see CRS Report R40748 (April 26, 2012).

Limited Liability Companies

9. Limited liability company (LLC) offers a very important nontax advantage (limited liability) plus the tax advantage of being treated as a partnership (or proprietorship, in the case of a single-member LLC) and avoiding the double taxation problem associated with C corporations.
 - a. All 50 states and the District of Columbia recognize LLCs.
 - b. States vary in the corporate characteristics allowed to LLCs.

Entity Classification

10. Classification of an entity was left to the taxpayer when the “check-the-box” Regulations were promulgated.
 - a. Under these regulations, entities with two or more owners can elect to be treated as a partnership or a corporation. Entities with one owner can elect to be taxed as either a sole proprietorship or a corporation. Election is made on Form 8832, Entity Classification Election. See Rev. Proc. 2009-41, 2009-2 CB 439 for guidance on filing late Form 8832. For a late Form 8832 by a foreign entity, see Rev. Proc. 2010-32, 2010-2 CB 320.
 - b. Under the default rules, if no election is made, multi-owner entities are treated as partnerships and single-owner entities are sole proprietorships. New entities using a default classification should not file Form 8332.
 - c. The “check-the-box” election is not available to entities incorporated under state law or are required to be treated as corporations under Federal law (i.e., publicly traded partnerships).

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- d. An LLC that elects to be treated as a corporation under the check-the-box Regulations may elect Subchapter S status. See, e.g., LTR 201140014 [late Form 8832 (Entity Classification Election) and late Form 2553 (Election by a Small Business Corporation) by LLC treated as timely filed].
- e. Recently, there has been a lot of litigation regarding the liability for unpaid employment taxes of single-member LLCs (default sole proprietorships). The issue addressed by the courts generally is whether the single-member (sole proprietor) or the LLC is liable for unpaid employment taxes of the LLC. Invariably the sole proprietor is found to be liable for the unpaid employment taxes. [See, e.g., *Comensoli v. Comm.*, 2011–1 USTC ¶150,368, 107 AFTR 2d 2080, 442 Fed. Appx. 412 (CA–6, 2011) (single member liable for unpaid employment taxes of LLC); and *Tony L. Robucci*, 101 TCM 1060, T.C.Memo. 2011–19 (single member liable for self-employment taxes on LLC earnings)].

2.2 AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS

An Overview of Corporate versus Individual Income Tax Treatment

- 11. There are similarities and differences between corporate and individual income tax treatment. The tax formulas for these two types of taxpayers are contrasted in Figure 2.1.
 - a. Determination of gross income is computed in much the same manner for corporations and individuals. However, corporations have no itemized deductions (as all its expenses are business deductions) nor do they have standard deductions or personal and dependency exemptions.
 - b. Property transaction tax rules apply to both corporate and noncorporate taxpayers.
 - (1) Includes definition of what are not capital assets (§ 1221) and nontaxable exchanges.
 - (2) Fewer exclusion provisions are available to corporate taxpayers. The exclusion permitted by § 121 (the sale of a personal residence) does not apply to corporations. This last point seems simple enough, but consider the following illustration.

Example. Ed is employed as general manager of Green Brewing Corporation. In this capacity, Ed is in charge of quality control, a feature highly touted by Green in advertising to its customers. To maintain constant quality control, Ed is required to live in a residence owned by Green and located adjacent to its brewery. If Green sold this residence for a gain, it may not use § 121 to exclude such gain. Had the residence been owned by Ed (and not Green Brewing Corporation), § 121 would be available to Ed.
 - c. Credits that are personal in nature (child credit, earned income credit) are not available to corporations.

- d. Charitable contributions and casualty/theft losses have substantially different limitations for corporations and individuals.

Accounting Periods and Methods

12. C corporations may choose a calendar year or a fiscal year for reporting purposes, but S corporations and personal service corporations (PSCs) are subject to restrictions in the choice of a fiscal year.
13. Cash method of accounting, available to individuals, is not available to most regular corporations. Cash method is allowed for S corporations, qualified PSCs and corporations with average annual gross receipts of not more than \$5 million.

ADDITIONAL LECTURE RESOURCE

Related Party Limitation. The § 267(a)(2) limitation on deducting accrued expense paid to related parties affects many closely held corporations, particularly those that are family owned. For purposes of the more-than-50% shareholder test, an individual is deemed to own the stock owned, directly or indirectly, by family members (i.e., siblings, spouse, ancestors, and lineal descendants) [§ 267(c)]. When a corporation's stock is only owned by family members, each shareholder will be a related party under the more-than-50% test. For many family-owned (accrual basis) corporations then, § 267(a)(2) will affect the deductibility of many different types of accrued expenditures (e.g., salary, bonus, interest, rent, and lease).

Example. Three brothers (cash basis, calendar year taxpayers) own all of the stock in Brown Corporation (accrual basis, calendar year taxpayer) and are its principal employees. After a particularly profitable year, in December 2013, Brown declares a bonus payable to each of its employees. Brown also accrues interest owed on amounts borrowed from its shareholders. The bonuses and interest are not paid until January 2014. Under the stock attribution rules of § 267, each of the brothers is deemed to own 100% of the stock of Brown. As a result, the bonuses attributable to the brothers and all of the interest are not deductible by Brown Corporation until 2014.

Capital Gains and Losses

14. Differences in corporate and individual taxpayer treatment of capital gains and losses.
 - a. Net capital gains of corporations are not subject to lower rates, as are net capital gains of individuals.
 - b. Corporate capital losses may only offset capital gains while individuals may deduct up to \$3,000 of losses in excess of capital gains.
 - c. Excess corporate capital losses are carried back 3 and forward 5 years to offset capital gains, while capital losses of individuals are carried forward indefinitely. When corporations carry over capital losses, they are treated as short term. For individuals, capital losses retain their original status as long term or short term.

ETHICS & EQUITY

A Motive that Wins! (p. 2-12). The key issue surrounding the tax treatment of the loss is whether the loss is a capital loss (the land was held for investment) or § 1231 loss (the land was used in trade or business). A capital loss would be subject to the capital loss limitation applicable to corporations, but a § 1231 loss would result in ordinary loss treatment. Every effort should be made by Canary to establish that its original motive for acquiring the land was for business use (i.e., plant expansion) and that such motive did not later change. Supporting documentation should include board of directors' minutes demonstrating intent of the purchase and plant construction plans (e.g., architectural plans, specifications) and plausible reasons why the expansion was not carried out.

Recapture of Depreciation

15. The § 291 amount is treated as additional § 1250 depreciation recapture. The result is a recharacterization of what would otherwise be § 1231 gain as ordinary income. Corporate taxpayers do not receive a preferential tax rate on long-term capital gains (e.g., a net § 1231 gain), but the recharacterization might reduce a corporation's ability to utilize capital losses in the current year.

Passive Losses

16. Passive loss limitations apply to closely held C corporations and personal service corporations (PSCs). However, closely held C corporations may offset passive losses against active income.

Charitable Contributions

17. Corporations are subject to limitations on their charitable contributions.
 - a. For accrual basis corporations, there is an exception to the rule that deductions for charitable contributions are allowed only for the year in which payment is made. Corporations may deduct charitable contributions in the year preceding payment if the contribution is authorized by the board of directors by the end of that year and is paid on or before the 15th day of the third month of the next year.
 - b. General rule that the amount of the deduction is fair market value on the date of the donation for long-term capital gain property and adjusted basis (or fair market value, if lower) for ordinary income property applies to corporations. However, there are exceptions to the general rule.
 - (1) Long-term (held more than 1 year) capital gain property contributed to certain types of private nonoperating foundations and contributions of tangible personal property that are not used in the charity's tax exempt function are limited to adjusted basis on the date of donation.

- (2) Contributions of inventory to charities for use in their exempt purpose and solely for the care of the ill, needy, or infants, or where the property is used for research purposes under specified conditions are subject to special rules. The deduction is measured by the adjusted basis of the property plus half of the appreciation on the property. However, the deduction cannot exceed twice the basis of the property.

Example: Rose Instruments, Inc., a scientific equipment manufacturer, donates inventory (basis of \$30,000, fair market value of \$70,000) to a qualified nonprofit university which will use the equipment in its scientific research endeavors. The amount of the charitable contribution is \$50,000 [$\$30,000 \text{ basis} + .5(\$70,000 \text{ fair market value} - \$30,000 \text{ basis})$] which is less than the ceiling of \$60,000 (2 x \$30,000 basis).

- c. Limitation is 10% of taxable income computed without regard to charitable contribution deductions, net operating loss or capital loss carrybacks, dividends received deduction, and domestic production activities deduction. Any contribution in excess of the 10% limitation is carried forward for 5 years.

ADDITIONAL LECTURE RESOURCE

Charitable Contributions of Inventory. The regulations provide guidance on determining whether inventory is related to a qualified organization's exempt purpose or function. The regulations also elaborate on the requirement that the corporate donor receive a written statement from the qualified organization regarding the use and disposition of donated inventory [§ 170(e)(3)(A)(iii)], as well as the determination of inventory basis (Reg. § 1.170A-4A.) In some cases, the disposition of inventory by a donee within 3 years of the date of contribution will result in recapture (gross income) to the corporation, equal to the excess of the corporation's charitable deduction for the inventory over its basis in such property [§ 170(e)(7)]. For a recent ruling where the enhanced inventory deduction was disallowed due to inadequate substantiation, see NSAR 2011380IF (August 15, 2011).

Domestic Production Activities Deduction

18. Domestic production activities deduction (DPAD) is based on the income from manufacturing activities (see Chapter 3 for a detailed discussion).
- a. DPAD is the lower of the following.
- 9% of qualified production activities income.
 - 9% of taxable income (modified adjusted gross income for individuals).
 - 50% of W-2 wages related to the qualified production activities income.
- b. Deduction is available to all types of business entities.

Net Operating Losses

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19. Individual and corporate taxpayers may have net operating losses (NOLs) that can be carried back 2 years and forward 20 years to offset taxable income.
- Corporations do not adjust their tax losses for capital losses as individuals do.
 - Corporations do not make adjustments for nonbusiness deductions or for personal exemptions as individuals do.
 - Corporations include their dividends received deduction in computing the NOL.
 - Like individuals, corporations may elect to forgo the carryback period.

Deductions Available Only to Corporations

20. Dividends Received Deduction (DRD). For dividend distributions received from other domestic corporations.
- Purpose of DRD is to mitigate (or eliminate) the triple taxation of corporate-source income.
 - Amount of DRD is limited as follows.

<u>Percentage of Ownership by Corporation Shareholder</u>	<u>Deduction Percentage</u>
Less than 20%	70%
20% or more but less than 80%	80%
80% or more and payor corporation is a member of an affiliated group with the payee corporation	100%

Example. During all of the current year, Silver Corporation (a calendar taxpayer) owned 4% of Bronze Corporation and 21% of Copper Corporation. Dividends received are: \$50,000 from Bronze Corporation and \$100,000 from Copper Corporation. Presuming the percentage of taxable income limitation does not apply, $DRD = \$115,000 [(70\% \times \$50,000) + \$80,000 (80\% \times \$100,000)]$.

- DRD is limited to a percentage of the taxable income.
 - Computed without regard to the NOL deduction, DPAD, DRD, and any capital loss carryback to the current tax year.
 - Percentage of taxable income limitation corresponds to the deduction percentage.

Example. Assume the same facts as in the preceding example. The taxable income percentage limitation for Silver Corporation is 70% for Bronze Corporation dividends and 80% for Copper Corporation dividends.

- Taxable income limitation does not apply if the corporate shareholder has a net operating loss for the current taxable year or in the case of the 100% DRD available to members of an affiliated group.

- e. In working with this myriad of rules, the following steps are useful.
- Multiply the dividends received by the deduction percentage.
 - Multiply the taxable income by the deduction percentage.
 - DRD is limited to the lesser of Step 1 or Step 2, unless deducting the amount derived in Step 1 results in an NOL. If so, the amount derived in Step 1 should be used. This is referred to as the NOL rule (Example 27).
- f. Dividends not qualifying for DRD.
- (1) Dividends on stock held for 45 days or less (90 days if preferred stock).
 - (2) Periods for which the corporation has diminished its risk of loss on the stock through a short sales do not count towards 45 day requirement (Reg. § 1.246-5). For a recent ruling where the diminished risk of loss resulted in a failure to satisfy the holding period requirement, see FAA 20121201F (November 10, 2011).
- g. DRD is reduced to extent of portfolio indebtedness (any indebtedness directly attributable to investment in stock).
- (1) Amount of reduction is limited to the allocable amount of the corporation's interest deduction on the portfolio indebtedness. For determining whether indebtedness is "directly attributable" to stock investment, see, e.g., *OBH, Inc. v. U.S.*, 2005-2 USTC ¶50,627, 96 AFTR2d 6801, 397 F Supp.2d 1148 (D.Ct. Neb., 2005) and Rev. Rul. 88-66, 1988-2 C.B. 35.
 - (2) If corporation owns at least 50% of voting and value of another corporation's stock, DRD for this stock is not subject to the reduction.
21. Organizational Expenditures Deduction.
- a. Such expenses may be amortized over a 180-month period starting in the month in which the business begins.
 - b. A special exception allows businesses to immediately expense the first \$5,000 of organizational costs. The exception, however, is phased out on a dollar-for-dollar basis when these expenses exceed \$50,000.
- Example. Fox Corporation had \$51,000 of organizational expenditures in the current year. Fox can elect to expense \$4,000 [$\$5,000 - (\$51,000 - \$50,000)$] of this amount and amortize the \$47,000 balance ($\$51,000 - \$4,000$) over 180 months.
- (1) In order for a corporation to qualify for this election, expenditures must be incurred before the end of the taxable year in which the corporation begins business. A corporation is deemed to make an election under § 248 to deduct organizational expenditures.
 - (2) A corporation may choose to forgo the deemed election by clearly electing to capitalize organizational expenditures for the taxable year in which the business begins. In this case, the organizational expenditures are not deductible until the corporation ceases to do business and liquidates (unless the corporate charter limits the life of the corporation).

- c. Startup expenses (investigation and operating expenses incurred before the business begins producing income) are different from organizational costs. However, the amortization, immediate expensing, and deemed election rules described in a. and b. above for organizational expenditures also apply to startup costs.
- d. Final Regulations (Reg. §§ 1.195-1 & 1.248-1) were issued in 2011 for organizational expenditures and startup costs (see T.D. 9542).

2.3 DETERMINING THE CORPORATE INCOME TAX LIABILITY

Corporate Income Tax Rates

22. Corporations compute their Federal income tax liability using the rate structure contained in § 11(b) (Exhibit 2.1 and inside front cover of text have rate schedules).
- a. An additional surtax of 5% is imposed on taxable income over \$100,000, but such tax is not to exceed \$11,750.
 - (1) Consequently, the tax savings from the lower rates [i.e., 15% (on the first \$50,000) and 25% (on the next \$25,000)] is completely phased out once taxable income reaches \$335,000 (Example 31).
 - (2) As noted in Chapter 1, the tax law shows definite favoritism towards small businesses.
 - b. At \$10 million corporate rate goes to 35% and at \$15 million, an additional 3% surtax applies (which brings total rate to 38% for that bracket). At \$18,333,333, the surtax is no longer imposed.
 - c. Personal service corporations (PSCs) are motivated to reduce taxable income as much as possible since they are taxed at the 35% rate on all taxable income.
 - (1) PSC is a corporation substantially owned by employees (current, retired, estates thereof, or estate beneficiary) and its business activities consist of the performance of services in qualifying fields.[§§ 11(b)(2) and 448(d)].
 - (2) This definition of a PSC also applies for purposes of the limitation on the cash method of accounting (outline item 13). However, for purposes of the limitation on the use of a fiscal year (outline item 12), definition of PSC is under §§ 269A(b) and 441(i)(2).

ADDITIONAL LECTURE RESOURCE

PSC Substantially All Activity Test. As to the function requirement, Temp. Reg. § 1.448-1T(e)(4) provides that the “substantially all” test is met if 95% or more of the time spent by

employees of the corporation is devoted to performing services in qualifying fields. A case addressing the function requirement is *Grutman-Mazler Engineering, Inc.*, 95 TCM 1551, T.C. Memo. 2008-140.

Similarly, Temp. Reg. § 1.448-1T(e)(5) establishes a 95% or more threshold for satisfying the stock ownership requirement. For a case addressing the ownership requirement see *Robertson Strong & Apgar Architects, PC*, T.C. Summary Opinion 2007-48.

Alternative Minimum Tax

23. Corporations (other than “small corporations”) are subject to an alternative minimum tax (AMT) that is similar to the AMT of individuals. Most adjustments and preferences are the same as for individuals, but the rates and exemption amounts are different. See Chapter 3 for a detailed discussion of the AMT.

Tax Liability of Related Corporations

24. A controlled group of corporations is entitled to one \$250,000 accumulated earnings tax credit, one \$40,000 exemption for the AMT, and is limited to taxable income in each of the first two brackets as though the group was one corporation. (See Examples 32 and 33) Controlled groups are parent-subsidiary corporations, brother-sister groups, combined groups and certain insurance companies.

Final regulations on which corporations are included in a controlled group were issued in 2009 (T.D. 9451). See Reg. § 1.1563-1 for definition of “controlled group of corporations.”

Final regulations on apportionment of tax items among controlled group members were issued in 2010 (T.D. 9476). See Reg. § 1.1561-1 et seq.

ETHICS & EQUITY

A Long Lost Relative? (page 2-24). Brenda owns more than 50% of the stock of both Pelican Corporation and Seagull Corporation. Thus, Pelican and Seagull are related corporations and members of a controlled group of corporations (brother-sister controlled group). As a result, the two corporations are treated as if they were one corporation for purposes of the tax brackets below 35%, the \$250,000 accumulated earnings credit, and the \$40,000 AMT exemption amount. The fact that the bookkeepers lacked tax knowledge means it is very likely that the prior years’ corporate returns failed to reflect the limitations applicable to related corporations. If this is the case, then you should advise the client of the error and recommend amended tax returns to correct the error. If the client refuses to amend any prior year’s return that is in error, then you must consider whether you can prepare a proper income tax return for 2012. [See, e.g., AICPA’s Statements on Standards for Tax Services (Statement No. 6: Knowledge of Error) in Chapter 17 of the text.]

2.4 PROCEDURAL MATTERS

Filing Requirements for Corporations

25. Corporations must file a tax return (Form 1120 or Form 1120S) on or before the 15th day of the third month following the close of the tax year.
 - a. Form 1120 should be used if the corporation does not have an S election in effect.
 - b. Corporations receive an automatic extension of 6 months by filing Form 7004 by the due date of the return.

Estimated Tax Payments

26. Corporations must make estimated tax liability payments unless the liability is less than \$500.
 - a. Required annual payment (including any AMT liability) is equal to the lesser of
 - (1) 100% of the current year's tax.
 - (2) 100% of the prior year's tax (prior year exception).
 - b. Corporations having taxable income of at least \$1 million in any of the prior three years (a "large" corporation) can use the prior year exception only for its first installment payment. Any shortfall of this payment must be remedied in the second installment payment.

Example. Blue Corporation has a \$1 million tax liability for the current year and an \$800,000 tax liability last year. Using the prior year exception, Blue Corporation's first installment payment is \$200,000 ($\$800,000 \div 4$). Second installment payment is \$300,000 [$(\$1 \text{ million tax} \div 4) + (\$250,000 \text{ required quarterly payment using the current year tax} - \$200,000 \text{ paid as first installment})$]. Third and fourth installment payments are \$250,000 each (See Example 34).

- c. Calendar year corporation's estimated payments are due April 15, June 15, September 15, and December 15.
- d. Penalties apply to underpayments.

Schedule M-1—Reconciliation of Taxable Income and Financial Net Income

27. Schedule M-1. Reconciles the net income per financial accounting books with taxable income per the tax return. That is, Schedule M-1 computes the book to tax differences for the year.
 - a. Schedule M-1 is required for corporations with total assets less than \$10 million.

- b. Taxable income reconciled to net income per books is taxable income before the dividends received deduction and the NOL deduction.
28. Schedule M-2 reconciles unappropriated retained earnings for the year. Computations for Schedules M-1 and M-2 are illustrated in Examples 35 and 36.

Schedule M-3–Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More

29. Corporations with at least \$10 million in total assets on their financial statements must report much greater detail relative to financial and tax income (loss) differences on Schedule M-3. This form is a response to the financial scandals.
- a. Any corporation required to file a Schedule M-3 does not file a Schedule M-1.
 - b. Objectives of Schedule M-3 are the following.
 - (1) Create greater transparency between financial statements and tax returns.
 - (2) Identify corporations engaging in aggressive tax practices by highlighting transactions that create book/tax differences.
 - c. See Rev. Proc. 2011-13, 2011 C.B. 318 for guidance on when adequate disclosure requirement of § 6662(d) (understatement of tax) is satisfied with regards to Schedule M-3.
30. Schedule M-3 has three parts.
- a. Part I is financial information and the net income (loss) reconciliation.
 - (1) Financial net income (loss) sources come from the SEC Form 10-K, financial statements, or the corporation’s books and records.
 - (2) Any income statement restatements or adjustments for the current or past 5 years should be included.
 - b. Part II reconciles net income (loss) of includible corporations with taxable income on the return. Corporations included in the financial reporting group may differ from the tax reporting group.
 - c. Part III reconciles expense and deduction items.
 - (1) Lists 36 expense and deduction items to reconcile.
 - (2) Differences between financial and tax amounts must be classified as being temporary or permanent.

Schedule UTP (Uncertain Tax Position Statement)

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31. For 2012 and 2013, Schedule UTP must be filed by corporations with \$50 million or more in assets (\$10 million or more in assets beginning in 2014) [Reg. § 1.6012-2(a)(4) and Announcement 2010-75, 2010-1 C.B. 428]. In general, requires reporting tax positions taken on a current (or prior) year's tax return and for which the corporation recorded a reserve for Federal income tax in its audited financial statements. Final Regulation [Reg. § 1.6012-2(a)(4)] was issued in 2011 (see T.D. 9510). See Chapter 14 for a discussion on financial reporting of tax positions.

Form 1120 Illustration

32. The illustrative example is useful in introducing the corporate Form 1120.

Solutions to Research Problems appear below.

SOLUTIONS TO RESEARCH PROBLEMS**Research Problem 1.**

A PSC [as defined under § 441(i)(2)] must use the calendar year for reporting purposes, unless the PSC can establish, to the satisfaction of the IRS, a business purpose for a fiscal year-end. [§ 441(i)(1)] (A fiscal year can also be elected under the provisions of § 444.) Approval of the IRS to adopt (or change to) a fiscal year under the business purpose exception is obtained by filing Form 1128, “Application to Adopt, Change, or Retain a Tax Year.” [Reg. §§ 1.441-1(c)(2)(i), 1.441-3(b)(1), and 1.442-1(b)(1)] In determining whether a PSC has established a business purpose for a fiscal year, consideration will be given to all of the facts and circumstances relating to the adoption of the fiscal year, including the tax consequences resulting from such adoption. [Reg. § 1.442-1(b)(2)]

Reasons sufficient to satisfy the business purpose standard:

- Fiscal year coincides with the entity’s natural business year. [Reg. § 1.442-1(b)(2)] In general, a natural business year exists if, for each of the 3 most recent 12-month periods that end with the last month of the requested fiscal year, 25% or more of the entity’s gross receipts were derived in the last two months of such requested fiscal year. (In addition to the 25% gross receipts test, a natural business year can also be established under the annual business cycle test and the seasonal business test.) [Rev.Proc. 2002-39, 2002-1 C.B. 1046] In some cases, a PSC satisfying the 25% gross receipts test will be deemed to have established a business purpose and obtain automatic IRS consent. [See Rev.Proc. 2006-46, 2006-2 C.B. 859.]

Reasons *insufficient* to satisfy the business purpose standard:

- Deferral of income to shareholders. [§ 441(i); Reg. § 1.442-1(b)(2)]
- The use of a particular year for regulatory or financial accounting purposes;
- The hiring patterns of a particular business;
- The use of a particular year for administrative purposes;
- The fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;
- The use of a particular year by related entities; and
- The use of a particular year by competitors. [Rev. Proc. 2002-39, 2002-1 C.B. 1046]

Research Problem 2**TAX FILE MEMORANDUM**

DATE: September 17, 2013
FROM: Leticia Ramirez
SUBJECT: Startup expenditures of John’s Premium Steakhouse, Inc.

Today, I talked with John Dobson regarding the tax treatment of startup expenditures related to opening of a new restaurant. Mr. Dobson recently formed John’s Premium Steakhouse, Inc.,

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with a contribution of cash in exchange for 100% of the corporation's stock. The corporation has since entered in leases for a building and restaurant equipment. Mr. Dobson requested guidance on the tax treatment of the various operating expenses the corporation expects to incur prior to the opening of the restaurant.

At issue: What is the correct tax treatment of startup expenditures?

Conclusion: Section 195 governs the deductibility of startup expenditures. Under § 195(c)(1), "startup expenditures" include amounts paid or incurred in connection with (1) investigating the creation or acquisition of an active business or (2) creating an active business. In addition, startup expenditures must be amounts that would be deductible as business expenses (under § 162) if incurred in connection with the operation of an existing active business. Startup expenditures that John's Premium Steakhouse might incur include rent or lease expense, licensing fees, utilities, employee salaries and benefits (e.g., for training and other work performed during the pre-opening period), advertising, and food costs (e.g., testing menu items during the pre-opening period). Startup expenditures do not include amounts paid for the purchase of depreciable property. Startup expenditures also do not include organizational expenditures, but such amounts are deductible (under § 248) in the same manner as startup expenditures.

Under § 195(b), a taxpayer can elect to deduct the first \$5,000 of startup expenditures and amortize the remainder of expenditures over the 180-month period beginning with the month the business begins. The \$5,000 expensing amount is reduced to the extent startup expenditures exceed \$50,000. Under Reg. § 1.195-1(b), the election to deduct startup expenditures is deemed made by claiming the proper deduction amount on the corporation's tax return for the year in which the business begins. (Alternatively, the corporation can forgo the election by including with the tax return a statement that clearly indicates an election to capitalize startup expenditures. Capitalized expenditures are deductible when the corporation ceases business and liquidates.)

The determination of when a business begins is important for two reasons. First, startup expenditures are not deductible until such time the business begins. Second, once a business has begun, the startup phase is done and further operating expenditures are deductible as trade or business expenses (under § 162). The IRS is authorized to prescribe regulations on when a business begins under § 195, but to date no such regulations have been issued. [§ 195(c)(2)(A).] However, the deduction for organizational expenditures has the same commencement of business requirement [see § 248(a)], and Reg. § 1.248-1(d) provides that a "corporation begins business when it starts the business operations for which it was organized." Further, the courts have held that for purposes of § 195, a taxpayer is not engaged in an business until such time the business has begun to operate as a going concern and performed the activities for which it was formed. See, *Richmond Television Corp. v. U.S.*, 65-1 USTC ¶9395, 15 AFTR2d 880, 345 F.2d 901 (CA-4, 1965), vacated and remanded on other grounds, 86 S.Ct. 233 (USSC, 1965); and *Yuri G. Glotov*, 93 TCM 1339, T.C.Memo 2007-147. In the case of John's Premium Steakhouse, the startup phase would terminate and the active business would commence when the restaurant begins serving meals to customers in the normal course of business.

Research Problem 3

TAX FILE MEMORANDUM

Date: May 2, 2013
From: Jonathan Smith
Subject: Tern Corporation

Facts: Tern Corporation, a calendar year C Corporation, is solely owned by Jessica Ramirez. Tern's only business since its incorporation in 2009 has been land surveying services. In Tern's state of incorporation, land surveying can be performed only by a licensed surveyor. Jessica, Tern's only employee, is a licensed surveyor. Jessica is not a licensed engineer. Upon audit of Tern's 2010 and 2011 tax returns, the IRS asserted tax deficiencies stemming from its conclusion that the corporation was a personal service corporation subject to the flat tax rate of 35%. Jessica believes that the IRS's determination is incorrect and she has requested advice on how to proceed.

At issue: Is Tern Corporation a personal service corporation under § 448(d)(2) and therefore subject to the flat tax rate of 35%?

Conclusion: Section 11(b)(2) provides that the taxable income of a qualified personal service corporation, as defined in § 448(d)(2), is subject to a flat tax rate of 35%. Under § 448(d)(2), a "qualified personal service corporation" means any corporation that satisfies both a function test and an ownership test. The function test requires that "substantially all of the activities" of the corporation involve the performance of services in one of eight specified fields, including engineering. [§ 448(d)(2)(A).] The ownership test requires, in general, that substantially all of the stock of the corporation is owned by employees (or retired employees) performing services for the corporation. [§ 448(d)(2)(B).] Since Jessica owns 100% of Tern Corporation and is the corporation's only employee, the ownership test is not in question.

Temp. Reg. § 1.448-1T(e)(4)(i) provides that the field of engineering includes surveying. Further, the provision notes that the "substantially all of the activities" requirement is satisfied if 95% or more of the time spent by employees of the corporation is devoted to the performance services in a designated field (e.g., engineering). Thus, Tern is a personal service corporation as defined under Temp. Reg. § 1.448-1T(e)(4)(i). In a recent case directly on point with our facts, a corporate taxpayer in the business of land surveying was held to be a personal service corporation as defined by § 448(d)(2). In *Kraatz & Craig Surveying Inc.* [134 T.C. 167 (2010)], the taxpayer argued that Temp. Reg. § 1.448-1T(e)(4)(i) was invalid in that it included surveying in the engineering field. The Tax Court rejected that argument, however, by noting, in part, that the underlying legislative language supported the regulation's interpretation. [See, e.g., H. Rep. No. 99-841, 99th Cong., 2d Sess., 1986, p. 285.] [The Tax Court also rejected the taxpayer's argument that state law is determinative of what is included in the field of engineering for purposes of § 448(d)(2).] Thus, the IRS's determination that Tern Corporation is a personal service corporation subject to the flat tax of 35% is correct and the tax deficiency should be paid.

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In the future, an attempt should be made to reduce or eliminate Tern's taxable income through increased compensation payments to Jessica.

Research Problems 4 through 6

These problems require that the student access various sites on the Internet. Thus, each student's solution likely will vary from that of the others.

You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world.

Make certain that you encourage students to explore all parts of the Web in this process, including the key tax sites, but also information found through the home pages of newspapers, magazines, businesses, tax professionals, government agencies, political outlets, and so on. They should work with Internet resources other than the Web as well, including newsgroups and other interest-oriented lists.

Build interaction into exercises wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.