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Director
Daniel C. Pfannstiel
College Station, Texas 77843

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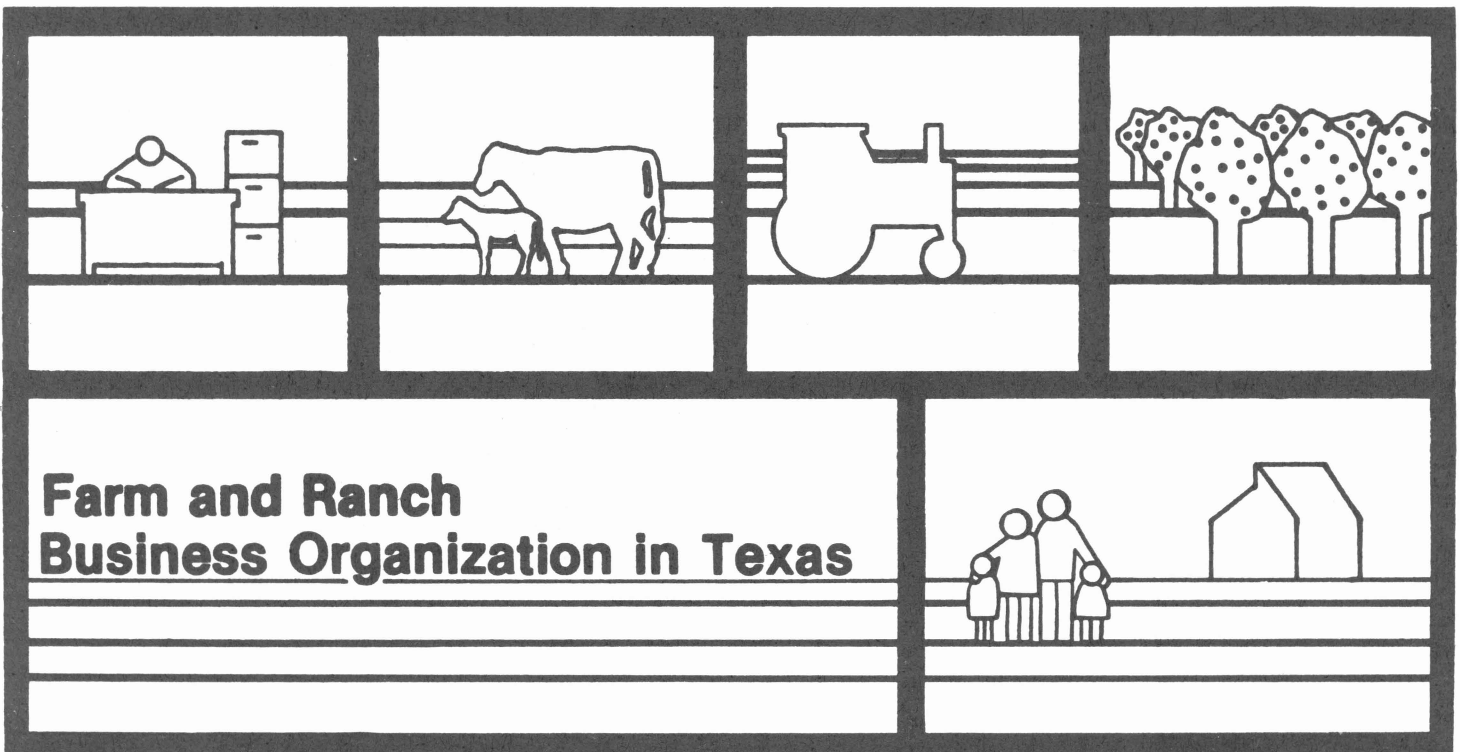
Answers to Common Questions on

Income Tax Implications of Farm and Ranch Corporations



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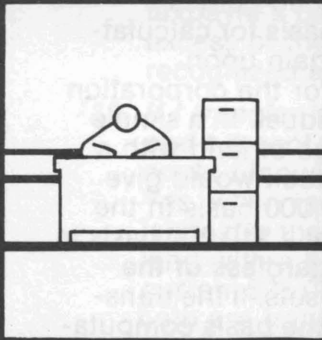
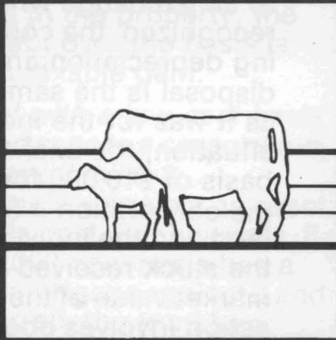
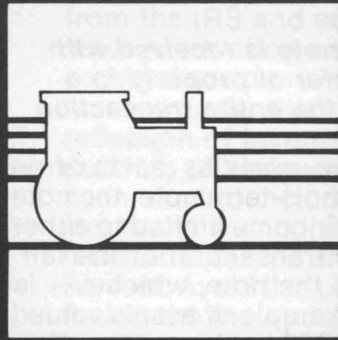
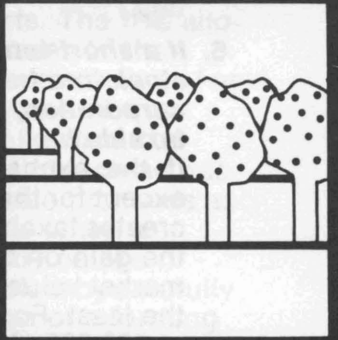
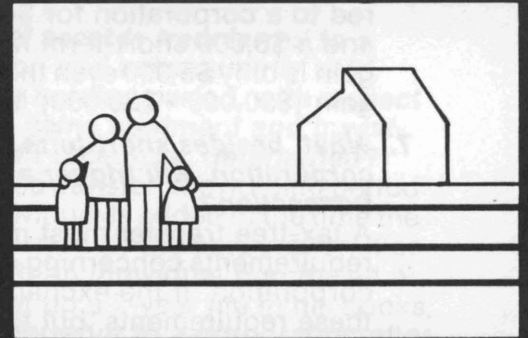
This publication is not to advise you of the validity of your contracts. The purpose is to provide educational information. Specific legal questions should always be directed to your attorney.

Editor: Jan McDaniel, Extension communications specialist — publications, The Texas A&M University System.

Income Tax Implications of Farm and Ranch Corporations



Marvin Sartin and Norman Brints*

Transfer of Assets to a Corporation

1. ***Will I create an income tax liability if I organize a corporation?***
In general, no. Individuals who transfer **property** to a corporation solely in exchange for **stock** and **securities** and **control** the corporation immediately after the exchange recognize no gain on the transfer. Likewise, a corporation does not recognize gain or loss on the issue of stock in exchange for property.

2. ***Does property include money?***
Yes, when organizing a corporation, the exchange of stock or securities for money has no tax implication whether the transferors control the corporation or not.

3. ***How is contribution of services handled by a corporation?***
Services exchanged for stocks or securities create ordinary personal income to the contributor in the amount of the value of services. If the contributor also exchanges substantial property, the total stock owned determines whether that person controls the corporation.

4. ***What is control of a corporation?***
For tax-free transfers, control is recognized as ownership of at least 80 percent of the combined voting power of all classes of stock and at least 80 percent of the total shares in all classes of stock.

5. ***What are securities in a corporate organization?***
Generally, long-term debt. The tax-free transfer sections of the Internal Revenue Service (IRS) Code permit exchanges not related to sales. Short-term debt instruments, maturing in 5 years or less, do not qualify as securities, but long-term notes, with terms of 10 years or more, should qualify. The term of a note alone does not classify it as a security. The Tax Court's controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest compared with similarity of the note to a cash payment. (See Question 21 for advantages of receiving securi-

*Extension economist—management and CPA and Extension economist—management, The Texas A&M University System.

ties.)

6. ***If a short-term note is received with stock in a transfer of property to a corporation, is the entire transaction taxable?***
If the exchange qualifies as tax-free except for the short-term note, the note creates taxable income limited to either the gain on the transaction or the fair market value of the note, whichever is the least. For example, if assets valued at $50,000 ($30,000 basis) are transferred to a corporation for $45,000 stock and a $5,000 short-term note, taxable gain is only $5,000 even though $20,000 gain ($50,000 - $30,000) is realized.

7. ***What, besides short-term notes from a corporation, will trigger a taxable transaction?***
A tax-free transfer must meet the requirements concerning control of the corporation. If the exchange meets these requirements, but the transferor receives something from the corporation other than stock and securities, the transaction involves **boot**. Stocks and securities are nonrecognition property; anything else received from the corporation is boot. A taxable gain to the extent of the lesser of the **gain realized** or the boot received must be recognized.

8. ***How is gain realized determined?***
Gain realized is the difference between the fair market value of assets and their **cost basis** (book value). For example, if a tract of land was purchased for $30,000 and current market value is $75,000, transfer of this land to a corporation would produce a $45,000 gain realized. If the land was exchanged for only stocks and securities, no taxable gain would be recognized. However, if the exchange included $60,000 of stock and securities and $15,000 of other property, cash or short-term notes, $15,000 of the $45,000 realized gain must be recognized (included in personal taxable income). Most transactions qualifying under the tax-free transfer rules do not involve boot.

9. ***If I transfer appreciated property to a corporation in a tax-free exchange, what is the corporation's cost basis of the property?***
In an exchange where no gain is recognized, the cost basis for calculating depreciation and gain upon disposal is the same for the corporation as it was for the individual. In a simple situation, the exchange of land with a basis of $10,000 for stock would give the corporation a $10,000 basis in the land and the individual a $10,000 basis in the stock received regardless of the market value of the assets. If the transaction involves boot, the basis computations are more complicated. The corporation's basis in the assets transferred is the individual's basis in the property plus any gain recognized. The individual's basis in the stocks or securities received is the basis in the property transferred, less the fair market value of boot received, plus the amount of gain recognized. A corporation assuming a debt constitutes a receipt of money (boot) to the transferor in basis computation.

10. ***If I transfer land with a market value of $50,000, a cost basis of $30,000 and a $20,000 mortgage to a corporation, am I deemed to have received money?***
Yes, but only for basis computation. Assuming you received stock in exchange for the land, your basis in the stock would be $10,000 ($30,000 original basis less the money received, $20,000). The corporation has a $30,000 basis in the land and a $20,000 basis in the mortgage. Transfer of debt to a corporation is not considered a receipt of money (boot) when computing taxable gain.

11. ***Why is the transfer of debt not boot with respect to computing taxable gain?***
The general rule for determining whether an individual incurs a taxable gain is that property exchange subject to a liability or a transfer of debts to a corporation is not boot or money received and does not disqualify the transaction as a tax-free exchange. In the example in Question 10, no taxable gain would be recognized by the taxpayer even though his or her basis in the stock was reduced. However, a tax liability will be created if debt is transferred to a corporation to avoid federal income taxes or if there is no bona fide business purpose in an exchange. Furthermore, if the property transferred is subject to liability which exceeds the

taxpayer's basis in the property, the excess of the debt over the basis is recognized as a taxable gain.

12. *If I transfer land with a low cost basis and a recent mortgage to a corporation, could I incur a tax liability?*
Yes, when the liability against an asset is greater than its cost. For example, if land with a $15,000 cost basis has a current $25,000 mortgage against it and both are transferred, the transferor would recognize a $10,000 gain. No tax liability would be incurred if the debt could be retained by the individual.

13. *If the situation in Question 12 was true, what would be the corporation's basis in the land and the individual's basis in the stock?*
Following the procedure outlined in Question 9, the corporation's basis of the land was the same as the individual's, $15,000, plus $10,000 of gain recognized, equaling $25,000. The individual's basis in the stock would be zero, computed as:

Basis of property transferred	$15,000
less	
Liability transferred	- 25,000
Subtotal	- 10,000
plus	
Gain recognized	+ 10,000
	- 0 -

14. *What would happen if the assets transferred had no cost basis?*
Pitfalls in tax-free exchanges are transfers of zero basis assets and of debt to a corporation. Assets could be inventories of farm commodities for a farmer who accounts on a cash basis or receivables of a typical business. Transfer of inventories of farm commodities or receivables and debt may result in a taxable gain in the amount of the debt. The aggregate amount of all liabilities compared to the aggregate adjusted basis of all assets transferred determines if any gain must be recognized.

15. *How are crops growing on land handled in a transfer to a corporation?*
The question of an individual deducting the expenses incurred before incorporation and the corporation receiving the income from the subsequent sale of the crops has brought negative reaction from the IRS and courts. The IRS allocates production expenses to the corporation to prevent a distortion of net income under the doctrine of **clear reflection of income.** Likewise, the doctrine of **assignment of income** has been used to include sale proceeds as income to the individual when a transfer occurred shortly before harvest. Avoid this problem by carefully timing the incorporation of a farming business.

16. *If a capital asset is transferred to a corporation and subsequently sold, how is the holding period, with respect to capital gains treatment and investment credit recapture, determined?*
In a tax-free transfer, the holding period of the individual is added to the time the asset is owned by the corporation. For example, if an individual purchased a **tractor, set up a 7-year life in his books, and transferred it to a corporation after 5 years, the corporation could keep the tractor 2 years, then sell it without paying back any of the investment credit.**

17. *When a tax-free transfer is made to a corporation, is the recapture of investment credit or depreciation a problem?*
Generally, when a transfer meets the tax-free requirements, no recapture of depreciation and investment credit is incurred. However, investment credit recapture is not triggered because the IRS code allows a **"mere change in the form of conducting a trade or business"**. To qualify, four conditions must be met. They are:

(1) transferred property which qualified for investment credit in prior use must also be used in a qualifying manner by the corporation;
(2) the transferor of property must retain a substantial interest in the corporation;
(3) substantially all of the assets necessary to conduct the trade or business must be transferred to the corporation; and
(4) the basis of the property when owned by corporation must be determined completely or partially by referenceto the individual's basis.

Criteria 2 and 3 usually cause problems for farmers.

18. *What happens if I do not retain a substantial interest in the new corporation or if I do not transfer substantially all of the old business assets to the corporation?*

The investment credit property transferred is assumed to be disposed and any investment credit taken on assets that have not reached the end of the determined lives will be subject to recapture. For example, if a tractor purchased 1 year ago and a combine purchased 5 years ago were both originally given 7-year lives, recapture of investment credit would require payback of all credit taken on the tractor and one-third of the credit taken on the combine.

19. *When I organize a farm corporation, will it use the calendar year as its tax year?*

Not necessarily. As a legal entity and a new taxpayer, a corporation can choose its taxable period and methods of accounting, inventory valuation and depreciation. The only tax attributes required to be carried over to a tax-free organization are the bases of the assets and their holding periods.

20. *What happens if the tax-free organization requirements are forgotten during an exchange?*

Corporate organization under the tax-free exchange criteria is not elective. If an exchange meets the criteria, it is tax-free. If an exchange does not meet the criteria (for example, the individual lacks control of the corporation), it is not tax-free. In situations where the criteria are not met, the individual recognizes taxable gain on the difference between fair market value and the cost basis on all assets transferred. The basis in the stocks and securities received will equal the fair market value of the assets transferred; and these assets will have their market value as a basis in the corporation.

Capitalization of a Corporation

21. *In a tax-free organization of a corporation, why should I consider receiving some securities (debt) instead of all stock?*

By taking some debt from the corporation, an individual prepares for a later distribution of income that will not be a dividend. Only long-term debts will qualify for tax-free treatment. Securities should be represented by formally drawn debt instruments, and should include a reasonable interest rate. Payment of interest and principal by the corporation is not a dividend to the individual.

22. *Is interest my corporation paid to me a deductible business expense?*

Yes, in most cases the corporation may deduct the interest paid. It is taxable income to the individual.

23. *What are some other considerations of receiving debt securities in a corporate organization?*

Payment of the principal amount is not deductible by the corporation nor is it taxable to the recipient. The holder can transfer interest to a family member or donate to charity without diluting control of the corporation.

24. *Is there any limit on the ratio of stocks to securities that can be issued?*

There are several problems in determining how much debt should be issued. Because the corporation must service this debt just as it would an obligation to an outsider, too much debt will increase fixed annual charges and can contribute to insolvency. In computing debt to equity ratios, the market value of assets is used and outside debt is included. Although no set ratio exists, a three-to-one, debt-equity ratio probably will withstand IRS scrutiny. A corporation's issuance debt for **essential** assets could also be questionable. Because of the complexities of these issues, an individual must rely on professional counsel in determining the amounts of stocks and debt to receive and avoid classification as a **thin** corporation.

25. *What is a thin corporation?*

A thin corporation has an excessive ratio of debt to equity. As previously mentioned, no rule gives a **safe** debt-equity ratio. Instead, the court considers the type of industry, common practices within the industry and the facts and circumstances of each case to determine whether debts are excessive.

26. ***What are the consequences of being classified as a thin corporation?***
The potential tax consequences are significant. If debt is owed to shareholders, it may be classified as equity interests (stock) and payments of interest (to the extent of corporate earnings and profits) will be considered dividends. Payments of principal will be a redemption of stock. If the debt is owed to outsiders, the question may arise whether the lender actually made the loan to the corporation or to the shareholder guarantor (cosignor) of the note. If it was made to a shareholder with subsequent contribution of the indicated amount to the corporation, corporate payment of that debt will not be a deductible expense and will be dividend income to the shareholder.

27. ***If I organize a corporation with only $1,000 in cash and lease my land and equipment to the corporation, will it be a thin corporation?***
This organization could be in jeopardy of a thin classification. No commercial lender would loan the large amounts of operating capital necessary for a farming corporation to an entity with only $1,000 net worth. The shareholder — note cosignor may be construed to be the borrower, and suffer tax consequences described in the answer to Question 26.

28. ***What is Section 1244 stock?***
IRS Code Section 1244 allows an incorporator to designate that losses within limits on stock issued to an individual or a partnership would be **ordinary losses** as opposed to **capital losses.** The aggregate amount that can be treated as ordinary losses is $100,000 for a husband and wife filing jointly or $50,000 for other taxpayers. Since stocks and securities are normally capital assets which produce capital gains and losses, this provision particularly benefits closely held corporations.

29. ***How does stock become Section 1244?***
Only common stock of a **small buiness corporation** may qualify, and it must be declared 1244 stock at incorporation. This stock must be received by an individual or partnership in exchange for money or property.

30. ***What constitutes a small business corporation?***
Aggregate money and other property received by a small business corporation for stock, as contribution to capital and as paid in surplus, cannot exceed $1 million. Assets are valued on their adjusted basis and not market value for this test. This requirement is of little concern to most small corporations since most of them are organized with much less than $1 million capital.

Taxation of Corporations

31. ***Are corporate tax rates similar to individual rates?***
No, traditional corporate tax rates differ substantially from individual rates. At this writing, corporate tax rates are 17 percent on the first $25,000 of profits, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000, and 46 percent for all profits exeeding $100,000. In comparison, an individual (married, filing jointly) reaches a marginal tax rate of 17 percent with taxable income slightly above $8,000; the marginal tax rate on $25,000 of taxable income is 32 percent; and the 46 percent rate is reached at about $45,000. Splitting income between an individual and a corporation can significantly reduce total income taxes. The Economic Recovery Act of 1981 changed the corporate income tax rates on the first $50,000 of corporate taxable

income for 1982 and subsequent years. In 1982 the rates will be 16 percent on the first $25,000 and 19 percent on the second $25,000. The rates in 1983 and thereafter will be 15 percent on the first $25,000 and 18 percent on the second $25,000.

32. *If income is first taxed at the corporate level and taxed again as dividends to an individual, how does incorporating save taxes?*
The corporation is taxed on its net profit. All business expenses are deducted. Because most persons forming close corporations provide services and are actively conducting the business, they are employees of the corporation. A corporation deducts the expenses of salaries and wages paid to employees, eliminating double taxation. Theoretically, tax liability could be minimized by drawing enough salaries and wages that the marginal tax rate for the individuals equals the marginal corporate rate on the retained profits. In practice, this is difficult to accomplish.

33. *If I own my corporation, why is equating the marginal corporate and individual tax rates difficult?*
Most businesses, especially farming, do not have easily predeterminable profit levels. As an employee of your corporation, your salary must be fixed the way an outsider would be paid by the corporation. While there is some opportunity to receive bonuses in high income years, making your salary a direct function of the business profit level likely would be construed as including a **constructive dividend.** Any wages and salaries (or any other expenses charged to the corporation) must be reasonable in relation to the cost of acquiring similar services from an outsider.

34. *What is a constructive dividend?*
A distribution of money or property to a shareholder that is not a justifiable remuneration for services, reimbursement for some legitimate expenditure, or payment of a bona fide debt is a dividend whether formally declared or not. Any such distribution that is not a formal dividend is a constructive dividend.

35. *Is determining corporate taxable income different from calculating income of a proprietorship of partnership?*
Yes, there are several differences between corporate and personal taxable incomes. Since proprietorships and partnerships are not taxable entities, income generated by these businesses accrues directly to the owners and is included in their personal taxable income. A corporation, a taxable entity, computes taxable income without benefit of deductions and exemptions specific to individuals (zero bracket amount, personal exemptions, and personal deductions). A corporation normally qualifies for an 85 percent deduction on dividends received from other domestic corporations while each individual taxpayer can deduct only $100 of dividend income. Charitable contributions by a corporation are deductible to a maximum of 5 percent of taxable income (with certain adjustments), but individuals may deduct 20 percent of adjusted gross income (up to 50 percent in certain cases). A corporation must amortize its organizational expenses over at least 5 years. These differences between corporate and personal taxable income will concern most small corporations.

36. *Are capital gains treated differently in computing corporate tax?*
Yes, corporations are not entitled to the 60 percent deduction of net realized capital gains that individuals may claim. Corporate capital gains are taxed at a flat rate of 28 percent. Thus, a corporation benefits from captial gains treatment only if its marginal tax rate exceeds 28 percent (if taxable income exceeds $50,000).

37. *What are tax preference items?*
Items upon which a minimum tax is applied. The principal items of tax preference ordinarily received by a small corporation include:

- the excess of accelerated depreciation over straight line on real property;
- the excess of percentage depletion deductions over the adjusted cost basis of each item of depletable property;
- and a portion of net capital gains.

38. *How is the minimum on tax preference items determined?*

A minimum 15 percent tax is levied on the total of tax preference items that exceeds $10,000 or the regular corporate income tax for the year, whichever is greater.

39. *Are the costs of issuing stock deductible?*
No, even though organizational expenses can be amortized, expenditures in issuing or reselling corporate stock are nondeductible capital outlays. Organizational expenses which may be amortized over at least 60 months include legal services for: drafting a corporate charter, by-laws, minutes of organizational meetings; necessary accounting services; expenses of temporary directors; organizational meeting expenses and fees paid to the state for incorporation.

40. *If I sell property to my corporation at a loss, can I deduct the loss?*
Losses from sales and exchanges of property between related parties may not be deductible. In the case of an individual shareholder and a corporation, direct or **indirect** ownership of more than 50 percent of the outstanding stock will disqualify the loss.

41. *What is indirect ownership of stock?*
Indirect, or constructive, ownership stock attributes stock owned by a person's family to that person. (Family is defined as brothers and sisters, spouse, ancestors and lineal descendants.) Also, any stock owned by a corporation, partnership, estate or trust is considered to be owned proportionately by its shareholders, partners or beneficiaries. Individuals who own stock in a corporation **also indirectly** own the stock of a corporation owned by any partner he or she may have.

42. *How are capital losses treated by a corporation?*
A corporation may deduct capital losses only from capital gains. Capital losses cannot be deducted from ordinary income.

Subchapter S Election

43. *What is a Subchapter S corporation?*
There are no **Subchapter S** corporations. Subchapter S refers to an election a qualifying corporation can make to have the corporate income or loss passed directly to the stockholders for tax purposes. This election generally precludes tax liability at the corporate level and allocates all income (loss) to the individual owners to be reported with their personal income.

44. *How does a corporation qualify for the Subchapter S election?*
Subchapter S applies only to domestic corporations which have 25 or fewer shareholders and only one class of stock. The shareholders must be individuals, estates or certain types of trusts. No nonresident alien can be a shareholder.

45. *Must all shareholders consent to the Subchapter S election?*
Yes, the election is valid only if all shareholders consent.

46. *How long does this election last?*
Subchapter S is effective for the taxable year for which it is elected and for all succeeding taxable years, unless it is terminated.

47. *How can the election be terminated?*
Five ways:

- a new shareholder refuses to consent to the election;
- all shareholders consent to revocation;
- disqualification;
- the corporation derives more than 80 percent of gross receipts from sources outside the U.S.;
- or the corporation derives more than 20 percent of gross income from **passive investment income.**

48. *What is passive investment income?*
Gross receipts from royalties, rents, dividends, interest, annuities and gains from sale or exchange of stocks or securities are passive investment income. The Subchapter S restriction to 20 percent of gross income does not apply to the first or second taxable year of active trade or business if total passive investment income is less than $3,000.

49. *If the Subchapter S election is terminated, will a subsequent reelection of this status be allowed?*
If an election is terminated or revoked, the corporation may not make a new

election for 5 taxable years beginning with the first year the termination or revocation was effective. This period of disqualification applies equally to any successor corporation.

50. *If Subchapter S is elected, will shareholders be taxed on corporate profits not distributed to them?*
Yes. In a normal situation a corporation will not distribute all of its profits to shareholders, but with a Subchapter S election all corporate profits will be taxed to individual shareholders. Shareholders on the last day of the corporation's taxable year must claim the amount they would have received as a dividend if the undistributed profits for the year had been distributed on a pro rata basis.

51. *Can a shareholder subsequently receive distribution of the profits that have already been taxed to him without additional tax liability?*
Yes, provided the distribution is money; a property distribution will not qualify. The right to withdraw previously taxed income is not transferable. If the stock is transferred (even to one's own estate), the right is lost. It remains in effect only as long as the Subchapter S election is in force. If the election is terminated or revoked, all rights to previous taxed income are lost. Because of these problems and the timing problem of determining corporate income and making proper distributions within a given year, a provision was instituted to classify all money distributed within the first 75 days of the year to persons who were shareholders on the last day of the preceding year as the corporation's undistributed taxable income from the preceding year.

52. *How are capital gains handled by a Subchapter S corporation?*
If the corporation has an excess of net long-term capital gains over net short-term capital loss, each shareholder is entitled to treat a pro rata portion of his **dividend income** (both constructive and actual) as long-term capital gain. This capital gain pass through applies only to distributions of current earnings and profits, and it cannot exceed the corporation's taxable income for the year.

53. *If I foresaw a substantial capital gain next year for my corporation, could I make a one-shot election under Subchapter S to pass through this gain?*
This opportunity is limited because the code provides a tax at the corporate level if:

- the excess of net long-term capital gain over net short-term capital loss exceeds $25,000 and exceeds 50 percent of the corporation's taxable income;
- the corporate taxable income exceeds $25,000;
- and the corporation was not subject to Subchapter S in the 3 immediately proceeding taxable years. Newly-formed corporations are excepted.

54. *Are net operating losses passed to shareholders?*
Yes, a primary use of Subchapter S election is for newly-organized businesses that expect operating losses in the initial years of operation. The loss pass through cannot exceed adjusted basis of the shareholders' investment. Shareholders of a normally profitable corporation who anticipate a large nonrecurring loss can hold a **one-shot election** to pass the loss to themselves without penalty, contrary to the situation with capital gain pass through in Question 53. Losses are allocated to all persons who owned stock during that loss year.

55. *What are some other advantages of Subchapter S election?*
Compared with a regular (Subchapter C) corporation, the primary advantages are: pass through of capital gains, pass through of net operating losses and no double taxation. If the alternative form of organization is a proprietorship or partnership, the election of Subchapter S for tax reporting does not impair any other traditional legal advantages of a corporation. Two important advantages are different taxable years for the corporation and the shareholder and employee fringe benefits. Fringe benefits for an employee-shareholder are greater in a regular corporaton.

56. *Why have I always considered Subchapter S to be a simple form of business organization?*
Since tax responsibility for business profits is passed to the shareholders,

corporations electing Subchapter S often are said to be taxed like a partnership, or even to operate like a partnership. In reality, the detailed requirements of properly operating a corporation electing Subchapter S tax reporting status involve some of the most complex situations faced by a family corporation. In some circumstances, problems associated with choosing this treatment are more than offset by advantages; however, most situations are best served by a regular (Subchapter C) corporation. Equating Subchapter S with simple is a gross error.

Dividends

57. *What constitutes a dividend?*
The definition of dividend in the IRS Code for income tax reporting is not necessarily consistent with state law. With respect to income taxes, a dividend is money or property from **earnings and profits** of a corporation distributed to shareholders whether or not formally declared.

58. *What are earnings and profits?*
The term earnings and profits is peculiar to the IRS Code. In general, earnings and profits is the cumulative after-tax corporate income. Numerous required adjustments add back certain items excluded from taxable income; others exclude deductions used in arriving at taxable income; and still other adjustments permit deductions not allowed in computing taxable income. Computation of earnings and profits is a complex task, but necessary for a corporation. Professional assistance is usually required. The concept of earnings and profits determines whether corporate distributions will classify as dividends.

59. *What are the tax consequences if a corporation makes a distribution when it does not have sufficient earnings and profits to cover it?*
If some earnings and profits exist, that amount of the distribution is a dividend. The remainder of the distribution to the extent of the shareholder's basis in the stock is a return of capital which does not create a tax liability. Any distribution in excess of the basis in the stock is a capital gain to the shareholder.

60. *Can a loan from my corporation to me be a dividend?*
If there is no intent to create a bona fide debtor-creditor relationship, the loan will be deemed a constructive dividend. The intent of the parties will be gleaned from the facts. For example, formal debt instruments including reasonable interest and actual interest and principal payments would be positive indicators that the loan was not a dividend. Otherwise, open accounts with no ascertainable date of maturity suggest a dividend. Corporate payment of a personal debt is a constructive dividend. A bargain purchase or rental of corporate property is a constructive dividend equal to the difference between the market value and the amount paid by the shareholder. Excessive payments for the purchase or use of a shareholder's property by the corporation or excessive salary to shareholders or their relatives are also deemed to be dividends.

61. *Can a dividend consist of anything other than money?*
Yes, anything of value distributed by a corporation to shareholders may comprise a dividend.

62. *How is the value of property dividends determined?*
For a corporation generally, no gain or loss is recognized on property distributed with respect to its stock. If appreciated property is distributed as a dividend, the corporation does not pay tax on the difference between market value and the cost basis. Seven specific statutory exceptions to the general rule involve: last-in-first-out inventories; distribution of property subject to a

liability in excess of the basis; distribution of installment obligations; depreciation recapture on distributed Section 1245 property; early disposition of investment credit property; redemptions of stock by distributing appreciated property; and distribution of assets from a collapsible corporation. To an individual stockholder receiving property dividends, the dividend is ordinary income based on fair market value of the property. To a corporate shareholder, the dividend is valued at the lesser of fair market value or adjusted basis of the distributing corporation.

63. *What are stock dividends?*
Stock dvidends are distributions by a corporation of its own unissued or corporate-owned (treasury) stock to shareholders. Straight forward pro rata distributions of stock or rights to acquire stock (stock rights) are not ordinarily considered a taxable dividend, especially if no other classes of stock exist. However, there are five statutory exceptions to the nontaxable classification of stock dividend. The first concerns an optional distribution where the stockholder can choose between stock and money or other property. The second involves receipt of preferred stock by common shareholders and receipt of common stock by preferred shareholders. Third, almost all distributions on preferred stock are taxable. Fourth, distributions of convertible preferred stock will be taxed unless substantially full conversion is likely in a relatively short period. Most important, a distribution will be taxable if some shareholders receive property and the proportionate residual equity interests of others increases.

64. *Why are stock dividends not usually taxable income?*
When stock distributions are proportionate to all existing shareholders, the receipt of additional shares of stock from the corporation does not provide anything a shareholder didn't already own. Proportionate ownership of the business has not changed and whether a given percentage equity interest is evidenced by 100 shares of stock or by 1,000 shares makes no difference.

65. *How is the basis in my stock determined after I receive a stock dividend?*
The basis in the original shares is allocated between the old and new shares in relation to the fair market values of the shares when each was distributed. The holding period for the new stock (for determining capital gains treatment) includes the period the old stock has been held.

Accumulated Earnings Tax

66. *What is accumulated earnings tax?*
Steeply graduated individual income tax rates encourage corporation owners to accumulate earnings within the corporate shell. The accumulated earnings tax is a penalty tax imposed on corporations that accumulate earnings and profits to avoid taxation of shareholders. Whether the tax applies to a specific situation depends on the purpose and intent of accumulations.

67. *What is the penalty tax rate for accumulated earnings?*
The accumulated earnings tax is 27.5 percent on the first $100,000 of accumulated earnings and 38.5 percent of accumulations of more than $100,000. This tax is imposed in addition to the regular corporate income tax.

68. *How much can a corporation accumulate without being subject to the accumulated earnings tax?*
A corporation can accumulate approximately $250,000 of earnings without any accumulated tax liability. In addition, a corporation can accumulate earnings for **reasonable business needs.**

69. *What are reasonable business needs?*
This is the most important issue in avoiding the accumulated earnings

tax; and there is no simple answer. No mechanical formula will cover all situations of reasonable business needs, and the code requires a corporation, in most cases, to produce a preponderance of evidence that an accumulation is justifiable. In general, the following specific grounds will qualify as reasonable business needs:

- bona fide expansion of business or replacement of fixed assets,
- purchase of a business enterprise,
- retirement of indebtedness,
- **working captial**
- investments or loans to suppliers or customers, if necessary to maintain the corporate business,
- and **other miscellaneous realistic needs** for liquidity.

70. *What is working capital?*
In the context used in Question 69 working capital refers to liquid assets used to finance the recurring operations of a business during its typical cycle. In general, working capital sufficient to cover reasonably anticipated costs of operating a business for an operating cycle can be accumulated.

71. *What kinds of things are included in miscellaneous realistic needs in the answer to Question 69?*
This could include many business needs. Some courts have looked sympathetically on:

- the need to compete,
- need to fund pension plans,
- reserves for various business risks and,
- potential liability from litigation.

No legitimate substantial business need for liquidity is prohibited.

72. *How do you know if a business need is reasonable?*
This is a difficult question. The burden of proof is on the corporation, which must try to legitimize accumulations by recording the anticipated uses of the monies in the minutes of directors' meetings, preparing cash flow analyses and creating sinking funds for debt retirement. The Regulations also list some indications that mean earnings are being accumulated beyond business needs. If any of the following criteria are met, the corporation is a prime candidate for accumulated earnings tax:

- loans to shareholders,
- expenditure of corporate funds for personal benefit of shareholders.
- loans to friends and relatives of shareholders
- investments in properties or securities unrelated to business,
- and retention of earnings to protect against unrealistic hazards.

73. *How is accumulated earnings tax computed?*
The tax applies to **accumulated income** which must be calculated first. In Step 1, the corporation's taxable income is reduced by: accrued income taxes; disallowed charitable contributions and disallowed capital losses. The net operating loss deduction, capital loss carryover and 85 percent dividends received deduction are also disallowed. The excess of net long-term capital gain over net short-term capital loss (adjusted for taxes) is eliminated from taxable income. In Step 2, taxable income, as adjusted, is then reduced by the dividends-paid deduction. This deduction is the sum of the dividends paid during the year and **consent dividends** for the taxable year. Consent dividend procedure permits shareholders to agree to treat a specified portion of the corporation's earnings and profits as a dividend, even though no actual distribution was made. The final step in the calculation of accumulated income is deduction of the accumulated earnings credit, $250,000. This credit must be adjusted to reflect any accumulations carried forward from prior years, since it is an over-all allowance for the corporation's life. To the extent that accumulated earnings exceed reasonable business needs, the tax of 27.5 percent on the first $100,000 and 38.5 percent on the remainder is levied.

Personal Holding Companies

74. *What is a personal holding company?*
Personal holding company (PHC) is a corporation controlled by a limited number of shareholders that derives a large percentage of its income from specified (passive) sources. Specifically, to constitute a personal holding company, a corporation must meet an income requirement and an ownership requirement. At least 60 percent of the corporate adjusted ordinary gross income must be **personal holding company income** (PHIC) and more than 50 percent of its stock (by value) must be owned, directly or indirectly, by five or fewer individuals.

75. *What constitutes personal holding company income?*
Personal holding company income is based on adjusted ordinary gross income (AOGI) of the corporation. AOGI is gross income less gains from the disposition of capital assets or Section 1231 assets and less depreciation, taxes, interest and rent incurred in connection with certain rental income and mineral royalties. Rents are personal holding company income if the AOGI from rents does not constitute 50 percent or more of a corporation's AOGI, and dividends paid for the taxable year equal or exceed the amount (if any) by which its nonrent personal holding company income for that year exceeds 10 percent of its OGI. A corporation primarily in the rental business may escape PHC status, but if it has substantial nonrental PHCI, it must distribute that as dividends. Mineral, oil and gas royalties are PHCI unless they constitute 50 percent or more of the corporation's AOGI, other PHCI cannot exceed 10 percent of the corporation's OGI, and business expenses, except for depreciation, interest and others allowable by IRS Code sections (other than 162), were at least 15 percent of gross income. Also, dividends, interest, annuities, copyright royalties, produced film rentals, compensation for use of corporate property by shareholders, personal service contracts and income from estates and trusts can produce PHCI.

76. *How is indirect stock ownership determined?*
Ownership attribution rules are principally:

- stock owned by corporations, partnerships, estates, or trusts is attributed proportionately to the shareholders, partners or beneficiaries; individuals are considered to own the stock owned by their brothers, sisters, spouse, ancestors or lineal descendants;
- members of a partnership are considered to own the stock owned by their partners;
- a person having an option on stock is deemed to own stock;
- and some convertible securities are considered stock.

With respect to PHCI, if more than 50 percent of a corporation's stock can be attributed to five or fewer individuals, the stock ownership requirement is met. Most close corporations cannot escape personal holding company tax based on the stock ownership test.

77. *What is the personal holding company tax rate?*
The PHC tax is a severe penalty. The tax rate is 70 percent applied on the undistributed personal holding company income. The Economic Recovery Act of 1981 reduced the rate to 50 percent for years subsequent to 1981.

78. *How is personal holding company tax computed?*
The corporaton's taxable income is adjusted by subtracting federal income taxes, increasing the deduction for charitable contributions from 5 percent to the 20 or 50 percent limit applicable to individuals, subtracting the excess of net long-term capital gain over short-term capital loss (less taxes) and by a few other items. Generally, from this adjusted taxable income, dividends (paid and consent) are deducted to arrive at the undistributed personal holding company income upon which the tax is levied.

Stock Redemptions and Liquidations

79. *Can I sell my stock back to the corporation?*
Yes, stock can be sold back to a corporation, but the tax consequences may be unfavorable. A transfer of stock to the issuing corporation in exchange for money or property may be deemed an ordinary sale, or it may be deemed a dividend. For an individual who controls a corporation before and after the sale of stock, dividend treatment is likely.

80. *What determines whether an exchange will be treated as a sale or a dividend?*
Stock redemptions are complex situations. In general, a redemption will not produce dividend income if it is not **essentially equivalent to a dividend;** the redemption of stock is substantially disproportionate among the shareholders; or the redemption **terminates the shareholder's interest** in the corporation. Redemption is substantially disproportionate if the ratio of voting stock owned after the redemption to the total voting stock is less than 80 percent of what that ratio was before the redemption. This treatment applies only to shareholders who own less than 50 percent of the voting stock immediately after the redemption.

81. *What terminates a shareholder's interest in a corporation?*
Ownership of stock by family members; by a partnership, estate, trust or corporation of which the terminating shareholder has an equity or beneficial interest; or ownership of options to purchase stock of the corporation constitute constructive ownership of stock and prevent termination of interest unless certain conditions are met. These conditions require that immediately after the exchange:

- the distributor has no interest in the corporation (including being an officer, director or employee) except that of a creditor,
- the distributor does not acquire any such interest within 10 years (except by bequest or inheritance),
- and the distributor files an agreement to notify the IRS of any acquisition of interest in the corporation.

In addition, the family attribution rules are not waived if any portion of the redeemed stock was acquired from a related person within the previous 10 years or if any related persons owns stock at the time of distribution and acquired any stock from the distributor within the previous 10 years unless that stock is redeemed in the same transaction. These limitations on the waiver of family attribution rules do not apply unless the transfer of stock had a principal purpose of avoiding federal income tax.

82. *What is not essentially equivalent to a dividend?*
The law includes this classification as a redemption that will not invoke dividend income; however, determining this is difficult. According to IRS Regulations dividend equivalence depends on the "facts and circumstances of each case", and the constructive ownership rules must be considered. The United States Supreme Court has held that business purpose is irrelevant in determining dividend equivalency and a redemption must result in a "meaningful reduction in the shareholder's proportionate interest in the corporation". This item has limited application for most corporations.

83. *What are the details of the rules of attribution with respect to constructive ownership?*
The rules differ slightly for stock redemption than for determining the corporation's status as a personal holding company. Attribution to individuals for redemption purposes includes stock owned by their spouse, children, grandchildren and parents. Stock attributed from one family member to another is not reattributed from the latter to family members. Stock owned by a partnership or estate is considered owned by the partners or estate beneficiaries in proportion to their beneficial interests. Stock owned by a trust is considered to be owned by the beneficiaries in proportion to their actuarial interest in the trust. Stock owned by partners, beneficiaries and shareholders is attributed to a partnership, estate, trust or corporation. A person owning an option to purchase stock is deemed to own the optioned stock.

84. *What is redemption to pay death taxes?*
If certain conditions are met, a redemption of stock can be treated as a sale and not as a dividend. The conditions include:

- the value of the redeemed stock must be included in the gross estate of the deceased;
- the value of the corporation's stock in the decendant's estate must be more than 35 percent of the gross estate or more than 50 percent of the taxable estate;
- the value of stock receiving this treatment cannot exceed the sum of the death taxes imposed and the funeral and administration expenses;
- and benefits of this treatment are available only for amounts distributed within a limited period after the death of a shareholder.

85. *What is a partial liquidation of a corporation?*
A partial liquidation from a tax perspective occurs in one of these three situations:

- a distribution in a series in the redemption of all of the stock of the corporation,
- a distribution in exchange for stock not essentially equivalent to a dividend,
- or a distribution which terminated one of two or more active businesses engaged in by the corporation.

86. *What are the tax advantages of having a stock redemption classified as a partial liquidation?*
In a distribution received in a partial liquidation by a stockholder in exchange for stock that is a **capital asset,** any gain (loss) is **capital gain** (loss).

87. *If complete liquidation is to be accomplished by a series of periodic distributions from a corporation, must shares of stock be surrendered at each distribution?*
No, when distributions (before the final distribution) are not accompanied by the surrender of shares of stock, generally shareholders who own only a single block of stock can apply the distributions against the total adjusted basis of their stock and recognize gain only after the basis has been recovered. If stock was aquired at different times and at different prices, the computation must be made share by share rather than by aggregating the basis of all shares.

88. *Does not equivalent to a dividend mean the same in partial liquidations as in stock redemptions?*
In the context of partial liquidations, this phrase denotes a **corporate contraction.** Although this phrase is in the law, it is an ambiguous area which provides little haven for most taxpayers. Also, the distribution must be in redemption of stock pursuant to a plan, and the redemption must occur within the taxable year the plan was adopted or the succeeding taxable year.

89. *Is the provision dealing with termination of one business of the corporation more definitive?*
Fortunately, it is; and most taxpayers need not worry with the corporate contraction vagarities. This provision requires a corporation actively conducting at least two businesses that have been operated for at least 5 years. One business may be sold and the proceeds distributed (or distributed in-kind) as long as the corporation continues to conduct the other business.

90. *How is a shareholder's gain or loss in a redemption or partial liquidation computed?*
The gain or loss is computed as though the stock had been sold to an outsider (assuming the distribution is not treated as a dividend) except a shareholder who owns, directly or indirectly, 50 percent or more of the corporation's stock cannot deduct a loss incurred in a stock redemption.

91. *If the distribution in a stock redemption is classified as a dividend, what happens to my basis in the shares that are surrendered?*
The basis in the surrendered shares should be transferred to the remaining shares owned, personally or constructively.

92. *If the distribution in a redemption or partial liquidation is property, what is the shareholder's basis in the property?*
If the shareholder is an individual, his or her basis will be the fair market value.

93. *Does a corporation recognize taxable gain on a redemption or partial liquidation?*
Gain to the extent that fair market value exceeds the corporation's adjusted basis will be recognized when a corporation distributes appreciated property in redemption of part or all of the stock of a shareholder. This is true even though the distribution is treated as a dividend. There are seven statutory exceptions to these provisions which include redemptions to pay death taxes and some redemptions of shareholders owning at least 10 percent of the corporation for the past year. Partial liquidations are not governed by these rules; instead, no gain at the corporate level is recognized.

94. *How is a distribution in complete liquidation treated by a shareholder?*
A liquidating distribution is treated as the proceeds of sale of stock by the shareholder. Any profit (loss) is the difference between the adjusted basis of the stock and the amount of the distribution.

95. *Are accumulated earnings in a corporation afforded capital gains treatment in liquidation of the corporation?*
Yes, usually, corporate earnings and profits not distributed as dividends will produce capital gain income upon liquidation if the stock is a capital asset of the shareholder.

96. *What is complete liquidation?*
Legal dissolution of the corporation is not required for a liquidation. In essence, when a corporation ceases business and its only activities are winding up its affairs, paying its debts and distributing remaining assets to shareholders, it is in liquidation. To avoid doubts about intent, a formal action to declare a liquidating distribution is recommended.

97. *How are gains (losses) computed when stock of the liquidating corporation was purchased at different times?*
The gain (loss) from a **liquidating distribution** is calculated on a per-share basis. If an individual acquired 100 shares for $1,000 and 200 shares later for $4,000, a liquidating distribution of on the first stock ($1,500 - $1,000) and $1,000 loss on the second purchase ($4,000 - $3,000).

98. *How is property in a liquidating distribution valued?*
The property is valued at its fair market value and the difference between that and the adjusted basis of the stock is shareholder's gain (loss).

99. *What are the implications if a liquidating corporation distributes property subject to liabilities?*
The amount of the liability is deducted from the fair market value to determine the **net** value of the property. For example, if property valued at $100,000 was distributed subject to a $30,000 mortgage, the shareholder receives net property of $70,000. A shareholder with $50,000 basis in the stock of the corporation would recognize $20,000 gain.

100. *Is there any way I can take assets back from the corporation without recognizing gain?*
A provision allows distribution of property to shareholders in a complete liquidation of a corporation with no recognition of gain under certain conditions. This opportunity exists for shareholders who file written elections to utilize the provision and those so electing must control at least 80 percent of the total voting power of all classes of stock. The liquidation must be made pursuant to a plan; the distribution must be for cancellation or redemption of all stock; and the property must be transferred within 1 calendar month. If all conditions are met, the gain recognized by the shareholder will not exceed the greater of: a rateable share of the corporation's undistributed earnings and profits; or the sum of money and the fair market value of any stock or securities received. Appreciation of assets will not necessarily create taxable gain under these provisions.

101. *What is the basis in assets received this way?*
The basis of the property received in such a liquidation is the basis in the stock less any money received and plus any gain recognized.

102. *Does a corporation recognize gain*

(loss) on property distributed in liquidation?
If the corporation adopts a plan of complete liquidation and distributes all of its assets within 12 months, it does not recognize gain or loss on most property sold or exchanged during that period. If the liquidation does not meet these criteria, the IRS is likely to rule that even though a code section states no gain or loss will be recognized in a liquidating distribution, principles of **assignment of income** and **clear reflection of income** provide a basis for taxing the accrued or potential income inherent in appreciated assets.

103. ***What types of property will not qualify for the above treatment in liquidation?***
Any property must be **sold or exchanged** to qualify. This includes gains and losses from the involuntary conversion of property and a liquidating distribution in-kind. Specifically excluded are inventories and installment obligations. Because a sale or exchange is involved, recapture of depreciation and investment credit taken by the corporation is required.

Collapsible Corporations

104. ***What is a collapsible corporation?***
It is a tax avoidance device where a corporation is formed; income is accumulated; liquidation is effected; and what would have been ordinary income is taxed as capital gains. The impact of the code section dealing with collapsible corporations can reach many corporations other than those at which it was aimed. The definition of a collapsible corporation is: a corporation formed principally for the production of property; to sell, liquidate or distribute before it has realized a substantial part of the taxable income to be derived from the property and before the shareholders have realized the gain attributable to the property. A corporation will be presumed to be a collapsible corporation if, at the time of the sale, exchange or distribution of the corporate assets the fair market value of the **Section 341** assets is 120 percent or more of the adjusted basis of these assets and at least 50 percent of the value of all corporate assets. **Section 341** assets consist primarily of property held for less than 3 years which is stock-in-trade (inventory) property held for sale to customers in the ordinary course of business and unrealized receivables from prior sale of 341 property.

105. ***What are the tax implications of being a collapsible corporation?***
The penalty is that all gains from the corporate distribution to the shareholder are treated as ordinary income instead of capital gains.

A business organized as a corporation is a legal entity separate from its owners, and is taxed on its net income. A business operated as a proprietorship or a partnership does not accrue income tax liability; rather, the net profits are reported as personal income by the owners. A normal distribution of after-tax corporate profits is a dividend which is taxable income to shareholders. Income to a corporation can be subject to double taxation, corporate tax on profits and personal tax on dividends distributed to the shareholders.

Because the organization of a corporation creates a separate legal entity, transfer of property to and from a corporation, dealings between a corporation and shareholders and specific corporate regulations have substantial income tax implications. Anyone incorporating a business should seek professional legal and accounting counsel. Our complex tax laws require a close working relationship with a knowledgeable tax advisor to avoid problems.

This publication is intended to acquaint persons considering incorporating a business with some income tax implications, problems and opportunities. It does not cover all situations or explain all possible considerations; the material, answers some common questions and provides a basis for more in-depth inquiries and discussions with tax advisors.

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