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Services™

Coaching Program

2010-7

Filing a C Corporation Tax Return

In this session, we're going to look at some of the most common tax issues for C Corporations. This is meant as an overview of the corporate compliance process and is by no means complete for all situations. C Corporations can be very complicated, especially if you have other shareholders. Owners of C Corporations may find that they've taken on extensive fiduciary responsibilities that they weren't really planning for. So it's important to understand that this eBook isn't intended to substitute for informed CPA and legal advice.

Tax Return Forms for a C Corporation

The federal form for a C Corporation tax return is Form 1120. There is also likely to be a state tax return, if the Corporation pays taxes in its home state. In addition, the Corporation will need to prepare and file a tax return in each state where it has nexus. That may mean needing to apportion the Corporation's income between different states for income tax purposes.

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C Corporation returns are due 3 ½ months after the fiscal year end. So, if the Corporation's year-end is December 31st, the tax return is due March 15th. If the Corporation's year-end is June 30th that would give a due date of September 15th. C Corporation owners can also apply for a 5-month filing extension by submitting IRS Form 7004.

Chances are though, that the C Corporation doesn't have a calendar year-end. That's because one of the biggest benefits to operating a C Corporation is the ability to select a different year-end. By staggering tax return due dates C Corporation owners can get some great tax planning opportunities and, often, some much-needed time to plan for sudden income windfalls.

Tax Form Depends on Tax Year Being Filed

If you've always filed calendar year returns for individuals and flow-through businesses, this may be a strange statement. But because C Corporations can move their year-ends you do have to think about which form to use. For example, a C Corporation whose year ended on December 31, 2009 is going to file a 2009 Form 1120 this year. But if the tax year ends on June 30th, the C Corporation is going to use a 2010 Form 1120. And a Corporation formed this year with a January 30th tax year, isn't going to file its first return until 2011, meaning it will need to file a 2011 Form 1120.

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The tax year will also determine what laws must be used in preparing the return. This is an important point. Tax changes enacted in 2010, for example, it may or may not be applicable to a C Corporation that year. It depends on what tax year the C Corporation has.

In the next few sections, we will go through some key points on actually completing the tax return, and then go over the most critical state and federal tax planning issues.

Personal Service Company

One of the boxes to check on Form 1120 relates to personal service company. A personal service company (PSC) is defined by the IRS as a specific type of business where the owner-shareholder provides his or her own services for the Corporation. The service is typically defined as something you need to be licensed to provide (i.e., doctors, engineers, accountants, lawyers, etc.). In addition, though, the IRS has recently added some non-traditional professions such as actuaries, performing artists, and consulting companies to the list.

Where PSC's are concerned, you will want to take most (if not all) of the income out in the form of salary. Otherwise, the PSC is going to pay a higher tax rate.

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Recently, we've seen the IRS question whether PSC tax treatment should have been selected for a C Corporation just based on the Corporation's name. Names that specifically relate to a personal service company can trigger this. Using the word "engineering," for example, in the Corporation's name could trigger a letter from the IRS.

Specific Audit Triggers for the C Corporation

In this time of budget cuts and huge shortfalls, there is one thing we can be certain of: more audits, and more aggressive audits. Here are some of the audit triggers for C Corporations. Meeting the criteria doesn't mean something is wrong. It just means the Corporation is more likely to be audited.

1. **Auto expenses.** Only the business portion of auto expenses are deductible. Be prepared with good records to prove the business use.

2. **Personal usage of a Leased Vehicle.** Make sure to include the personal portion use of a leased vehicle by an officer on his W-2. It's risky to file a return stating the leased vehicle is used 100% on business.

3. **Officer life insurance is expensed on a tax return with no M-1 adjustment.** This is a non-deductible expense. If a C Corporation pays for life insurance for its officers, the cost is usually shown as an M-1 item. There is a deduction allowed for the payment on $50,000 of term insurance, provided the insurance is nondiscriminatory.

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4. Excessive meals and entertainment. Meals and Entertainment expenses are expenses that are incurred in course of normal business. A high percentage of meals and entertainment in relationship to gross income can trigger an IRS audit. The IRS will demand proof of who was entertained and proof that it helped the business.

5. Loans to officers instead of payroll. One of the big issues C Corporation owners face is how to get the money out. After you've maximized tax benefits and taken a reasonable salary, now what? Taking the money as a dividend means double taxation. It's not a deductible expense for the Corporation and it's a taxable event for the recipient. The easy answer is to take out a loan from the Corporation. Unfortunately, that's exactly what the IRS is looking for.

On review, the IRS will closely compare the amounts of officer loans relative to that officer's salary. If the IRS finds that little or no officer salary has been reported, yet substantial money has been paid out as a loan, watch out. The IRS will often view this as an abusive transaction to avoid payroll taxes. In that case, the IRS may choose to recharacterize the loans as payroll (and assess delinquent filing of a payroll tax returns, and charge interest and penalty on the payroll tax liabilities due). Or, if there has been a reasonable amount of salary paid, the IRS will instead recharacterize the loans as a "constructive dividend."

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6. Retail business with zero ending inventory. If a Corporation is in the business of selling products, yet has no ending inventory recorded, it's just asking for an audit. In real life, it's almost impossible to have a zero ending inventory. The IRS is quick to spot what is going on here. By having no inventory recorded, there is more cost of goods sold. That means lower taxable profit and lower tax. It's not just C Corporations that get in trouble with this one.

7. Profit margins are inconsistent with prior years. The IRS has the ability to test a Corporation's profit margin versus previous years. If the margin changes dramatically, there is a chance that the return will kick out for audit.

The IRS is also doing tests of company ratios compared to others in the same industry. That's why it is so important to make sure you've selected the right industry code on the return.

8. The Balance Sheet does not balance. This situation is pretty obvious, in that it shows that the Corporation's books do not balance, meaning that the entries made on the Corporation tax return won't balance either. This shows a lack of attention to detail and to the IRS it could easily point to a business without proper records to substantiate expenses.

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9. Retained earnings from prior period not properly rolled forward to current year. Once again, this demonstrates a lack of attention to detail and sloppiness, and the IRS would want to investigate the return. Face it. If they feel if you aren't paying attention to the details here, you probably have bad records. Bad records equal lost deductions and more money in the government's piggy bank.

10. Form 1096 Annual Transmittal not filed timely. A Form 1096 is a transmittal form that is typically filed along with copies of all the 1099s. If a C Corporation files any of these required reports late, it sticks out, as just one more indicator of a lack of attention to detail.

11. No interest paid on officer loans or no interest received on officer loans. Anytime a Balance Sheet shows loans to or from an officer, the IRS will take a look to determine whether the Corporation received interest on loans it made to an officer, or paid interest on loans granted by an officer. A 1099-Int would have to be issued to the Officer who was paid interest on the Officer Loan.

The absence of interest income by the Corporation would invite an IRS scrutiny. Even though the loans may be proper and bona fide, they could be disregarded as loans and recharacterized as salary. This would cause imposition of substantial penalties and interest on late payment of payroll taxes as explained on 5) above.

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The absence of interest expense by the Corporation would also invite IRS scrutiny. Again, a bona fide loan to the Corporation should result in interest income to the officer making the loan. This time, the IRS could impose penalties and interest on underreporting of interest income on the officer's personal tax return.

That's why it is important to document all loans made by or paid to a Corporation and to have a loan document outlining the loan's payment terms, interest rate and duration. It's also important to at least record the accrual of interest if the loan cannot be paid and at the end of the year and to make sure that a proper 1099-Int is prepared and filed along with the Annual Transmittal Form 1096.

Establishing State Nexus

We've been talking about nexus a lot. You may want to go back and review the entire Nexus session to make sure you've fully taken into account all the states in which the C Corporation might have a connection.

There can be two levels of nexus exposure for a C Corporation: nexus for sales/use tax and nexus for income tax. In this case, we're going to focus just on the nexus for income tax.

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In general, nexus is created for income tax purposes if the Corporation earns income from sources within the state, owns or leases property in the state, employees personnel in the state in activities that exceed mere solicitation, or has capital or property in the state. The exact details are determined by state statute and case law, so it does vary from state to state.

At this moment, neither Congress nor the U.S. Supreme Court have legislated or ruled recently on this hotly contested topic. All we have for guidance are largely 20+ year-old statutes and a couple of key U.S. Supreme Court cases.

Public Law 86-272 established that next for income tax purposes can not be established merely because sales of tangible personal property are solicited within states. In fact, under this Public Law, states are prohibited from imposing a tax if the Corporation's only connection with the state is the solicitation of orders or sales of tangible personal property, where such orders are accepted and shipped or delivered from outside the state.

Note the two pieces to the exception: (1) it's a sale of tangible personal property and (2) orders are accepted and shipped or delivered from outside the state.

In Quill Corp v North Dakota, the U.S. Supreme Court ruled that a taxpayer must have some physical presence in a state to be subject to collection responsibility for the state's use tax. Although this ruling was centered on use tax, it's also helpful to consider for income tax.

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In Geoffrey, Inc v. South Carolina Tax Commission, it was held that a Delaware holding company that owned only intangible property used in South Carolina was subject to income tax. In this case the intangibles were licensed for use in the state and income was received in exchange for their use within the state of South Carolina.

And what we're left with is a lot of confusion. California has a new law beginning in 2011, that if left unchecked, will claim nexus if any part of the sales process is in the state of California, any employees are in California (and possibly any independent contractors as well), any personal property is in the state or if any owner is a resident. This seems to fly in the face of previous rulings.

Time will tell what is going to happen with Nexus. For more information on nexus, please check out State Nexus: The Big Issue for Business Owners in 2010. There is also plenty of information in our Forums on nexus developments.

Reasonable Compensation

In the case of an S Corporation, the IRS wants to see that you're taking enough of a salary. That's because the alternative, a distribution, is not subject to payroll taxes. If you have an S Corporation with no salary, count on the IRS targeting you for audit and trying to claim that all income is subject to payroll tax.

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In the case of a C Corporation, the IRS is going to flip-flop and want to make sure you're not taking too much of a salary. That's because the alternative, a dividend, is not a tax deduction for the Corporation but it is taxable for the recipient. Dividends from C Corporation are the only instance of double taxation for the C Corporation.

That's where the principal of reasonable compensation comes into play. What is reasonable compensation for the work that an owner is doing? Let's take a look at what the IRS has to say.

The case of Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo 2001-81, demonstrates the long-standing IRS position. Pediatric Surgical Associates, a professional Corporation taxed as a C Corporation, consisted of shareholder surgeons, who received monthly salaries and cash bonuses based on the net profit of the Corporation, and non-shareholder surgeons, who received only monthly salaries. Pediatric Surgical Associates deducted the entire amounts paid to the shareholder surgeons as officers' compensation. The Court, relying on its own calculations regarding the Corporation's profits and expenses, found that the deductions claimed for shareholder surgeon salaries exceeded the reasonable allowances for services actually rendered by them and re-characterized them as disguised dividends, creating additional taxable income at the corporate level.

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Section 162(a)(1) of the Internal Revenue Code (the "Code") provides, under a two-prong test, a "reasonable allowance for salaries or other compensation for personal services actually rendered." Historically, the courts have focused on the reasonable compensation prong of the analysis when deciding on the deductibility of compensation by a taxpayer.

The ruling in Pediatric Surgical Associates, however, represents a shift in the traditional analysis as the Court placed its findings squarely on the second prong of the test, stating, "We do not believe that whether the return amounts were reasonable in amount is actually in question. The question … is whether the amounts were paid to shareholder surgeons purely for their services."

The leading case in the area of reasonable compensation for services is from the tax court case of Richlands Medical Association v. Commissioner, T.C. Memo 1990-660. In Richlands, the tax court permitted the amount of compensation for the shareholder-employees to be attributed to: (i) 100% of the collections from direct patient services; (ii) their medical department responsibilities at the local hospital; and (iii) their responsibilities as officers of the professional Corporation.

The Court then recharacterized the remaining income paid the shareholder surgeons as a constructive dividend. The Court specifically noted that no dividends had been paid and that the bylaws of the professional Corporation provided that all net profits would be

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distributed as bonuses so that there would never be any net profits from which dividends could be paid. Thus, while the Court in Pediatric Surgical Associates clearly framed the issue as being one of whether the compensation was paid purely for services, Richlands effectively incorporated the same logic in its ruling.

Pediatric Surgical Associates and Richlands illustrate that, no matter how reasonable the compensation being paid to shareholder-employees may appear, when a professional Corporation employs non-shareholder associates the IRS may successfully argue that some amount of profit of the professional Corporation must be attributable to the efforts of the non-shareholder associates and that this amount of profit cannot be treated as compensation for services of a shareholder-employee, but instead must be paid out as a dividend.

Reducing the Chance of an Audit for Reasonable Compensation for Services

Most personal service companies end up electing S Corp treatment, simply because it's too hard and expensive to pull all the income out as salaries at year-end.

But in all other cases, be ready for an audit challenge by the IRS if the income is too high.

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Documentation

All compensation paid to officer-shareholders should be documented in written employment agreements that are executed at the beginning of the fiscal year (or that cover several fiscal years in advance) and are authorized by the board of directors.

If there are raises or bonuses paid, the reasons for granting such raises should be reviewed by the board of directors and written into the appropriate minutes. Such minutes should include, among other things, statements regarding the responsibilities, skill, and income earned by the shareholder.

Bonuses

If the C Corporation gives year-end bonuses, tie them to employee performance. If possible, include the formula for calculation in an employment agreement. Regulations Section 1.162-9 specifically mentions bonuses as an area that may generate unreasonable compensation. And that means an IRS inquiry.

Salaries

Make sure that salaries are either a stated dollar amount or based upon a formula amount. The safest plan is to use a stated salary that is established in an employment agreement at the beginning of each fiscal year. This salary should be placed sufficiently high so that all

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compensation which is anticipated to be paid to the shareholder during the year can be paid within the stated salary figure without creating a bonus; however, avoid setting excessively high salaries which are likely to result in large amounts of unpaid salary at the end of the fiscal year.

Compensation based upon formulas is specifically recognized as acceptable under Regulations Section 1.162- 7(b)(2). If such formulas are negotiated at arm's-length they will normally be upheld and the compensation paid under them will be deemed to be reasonable. However, in closely held Corporations the IRS assumes that such formulas are seldom negotiated at arm's-length. Because of this, the IRS typically takes the position that formula compensation in a closely-held Corporation is a way for the shareholders to divide the profits of the Corporation.

If compensation formulas are used in a professional Corporation, make sure they're based on the production of each individual owner, rather than on the overall net profits. For example, in a medical practice the Corporation could calculate payment as a percentage of a doctor's net collections, since this reflects the actual services of the doctor-shareholder, plus the value of other administrative or managerial services.

All direct and indirect benefits, including salary payments, employee benefits, and retirement plan contributions (whether or not vested) are generally considered within the term "compensation." Although examining IRS agents often overlook these indirect forms of

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compensation and deal primarily with salaries and bonuses, care should be taken to include all forms of compensation in making projections regarding reasonableness.

Payment of Dividends

As illustrated by Richlands and Pediatric Surgical Associates, it's a good idea (and can lower IRS challenges) for a profitable professional Corporation to pay some amount of its income as a dividend. The dividend paid should typically be computed as a percentage of investment capital.

It is difficult to determine what percentage of net capital should be paid out as a dividend, but don't make it too small. If the dividend becomes so small that it is viewed as simply a token dividend, most commentators feel that it will be challenged by the IRS and disregarded. Since professional Corporations normally have a substantially smaller amount of capital invested, this dividend can be smaller than that normally paid by a business Corporation, but it should be at least a "substantial, significant dividend."

Fringe Benefits

We've all read the stories of corporate executives receiving extraordinary benefits that other employees don't get. But any property or service that an executive receives in lieu of or in addition to regular

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taxable wages is considered to be a fringe benefit, and one that may be subject to taxation.

In 1984, the Code was amended to include the term fringe benefits in the definition of gross income found in Section 61. The IRS ruled that a fringe benefit provided in connection with the performance of services, regardless of its form, must be treated as compensation and included in income.

Whether a particular fringe benefit is taxable depends on whether there is a specific statutory exclusion that applies to the benefit. For example, when Section 61 was amended, Section 132 was added to provide exclusions for certain commonly provided fringe benefits that had previously not been addressed in the Code. Section 132 provides exclusions for working condition fringes, deminimis fringes, no-additional-cost services, qualified employee discounts, qualified moving expenses, qualified transportation fringes, and qualified retirement planning services.

And, even though it's clear that fringe benefits are taxable, Corporation owners sometimes don't treat them that way for income and employment tax purposes. Sometimes employers reclassify a taxable fringe benefit under expense accounts other than compensation, allowing them to exclude the value of the benefit from income and employment tax calculations.

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Because the tax treatment of fringe benefits can vary depending on the facts and circumstances under which they are provided, it may be helpful to follow a 3-step analysis when examining a particular item.

- First, identify the particular fringe benefit and start with the assumption that its value will be taxable as compensation.

- Second, check to see if there are any statutory provisions that exclude the fringe benefit from the recipient's gross income.

- Third, value any portion of the benefit that is not excludable for inclusion in the recipient's gross income. Fringe benefits are generally valued at the amount that would otherwise be paid for that benefit in an arm's length transaction.

Potential Issues

There are several potential issues regarding fringe benefits, including employment and income taxes. Therefore, it's important to always keep these four points in mind:

- Is the expense deductible by the Corporation?
- Is the amount excludible from gross income of the executive?
- Is the executive receiving personal benefit from the Corporation?
- Does the benefit exceed the §162(m) limitation?

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Let's take a look at some of the most common fringe benefits and how problems can arise.

Athletic Skyboxes/Cultural Entertainment Suites

In the case of a skybox or other private luxury box leased for more than one event, the deductible amount allowed under Code Section 274(l)(2) shall not exceed the sum of the face value of a non-luxury box seat ticket(s) for the number of seats in the luxury box. Luxury boxes rented by related parties or individuals are treated as a single lease in determining whether a luxury box is leased for more than one event. See Notice 87-23, 1987-1 C.B. 467, 469. The remaining amount for attendance at the event is limited to ordinary and necessary business expenditures that also satisfy all the requirements under Section 274(a), (d), and (n) for deducting entertainment expenses. Similarly, a purchase of a skybox is the purchase of a facility subject to Section 274(a). Catered events may need examination to verify the deduction limitations of IRC §274(n) have been correctly applied. If the purchased or leased skybox is used personally by the top executives of the Corporation, the value of the benefit may be taxable income to the executives.

Key points: The deduction is limited to the amount of non-luxury box seat tickets for the event (i.e., if the box seats 15 people, the deduction is equivalent to 15 regular seats outside the luxury box). And, be careful who uses the box. If seats are limited to just the Corporation's executives or owners use the skybox, then the deduction turns into a taxable benefit to the executives or owners.

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Awards/Bonuses

Generally, all payments in whatever form, are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. These include (but are not limited to) wages, salary, bonuses, severance pay, fringe benefits, pension benefits and other deferred compensation.

Awards and/or bonuses paid to a Corporation's owners should usually be considered taxable to the owners. Seminar promoters often make all kinds of claims ("My company gave me this Rolex!"), but they don't tell you the whole story. They are likely claiming the gift as compensation or they are illegally evading taxes.

Club Memberships

Since 1994, there has been no Corporation tax deduction allowed for club dues. This includes all types of clubs, including social, athletic, sporting, luncheon clubs, airline and hotel clubs and "business" clubs for all amounts paid or incurred after 1993.

Regulations 1.274-2(a)(2)(iii) and (e)(3) (ii)(b) clarifies that the purposes and activities of a club, and not its name, determine whether it is covered under the disallowance provision. A Corporation has the choice of either including the value of the club membership in the employee's income or otherwise, not taking any deduction for the club dues.

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Corporate Credit Card

Many companies provide corporate credit cards to executives and other employees. The difference between the two is generally the method of reimbursement. Top level executives are permitted to use a card at will. A monthly statement may be mailed directly to the Corporation and the account may be paid in full without the submission of a business expense report. Other employees are generally required to submit an expense report and are reimbursed for business related expenses. Personal expenses paid on behalf of executives are taxable fringe benefits that should be included in wages.

All Corporations need to have what is called an ‘accountable’ plan. This means that owners, executives and others need to substantiate all charges, in this case, made to the corporate credit card. If the charges were for business purposes, then there must be back-up. Without that proof, it is assumed that they were for personal expenses and the employee either pays them back or they are added to their Form W-2 as compensation at year-end.

Executive Dining Room

Meals furnished on the Corporation’s business premises and for an employer’s convenience are excludable from income under Code Section 119.

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If there’s an on-site Corporation-operated eating facility, the rules of Code Section 132(e)(2) must be met in order for the income to be excludable as a de minimis fringe (i.e., not included in employee gross income). That means meeting the following four tests, and making sure that the eatery is non discriminatory, and available to everyone:

1. The facility is owned or leased by the employer.
2. The facility is operated by the employer.
3. The facility is located on or near the business premises of the employer, and
4. The meals furnished at the facility are provided during, or immediately before or after, the employee's workday.

Loans

One IRS target right now is low or no cost loans made to owners or executives. In some instances, the terms have been such that the loan is really disguised compensation. Prove that there really is a loan by:

1. Creating a Promissory Note.
2. Show cash payments according to a specified repayment schedule.
3. Charge Interest, and
4. Make sure there is security for the loan.

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Qualified Employee Discounts

This exclusion applies to a price reduction given to an executive on qualified property under Section 132(c)(4), or services offered to customers in the ordinary course of the line of business in which the employee performs substantial service. It does not apply to discounts on real property or discounts on personal property of a kind commonly held for investment (such as stocks and bonds) under Section 132(c).

There are specific rules that must be followed if the employee is highly compensated (see Notice 2002-71, 2002-45 I.R.B. 830). Treasury Regulation 1.132-1(b)(1) does not allow company discounts for directors and independent contractors. It has become quite common for former officers to be retained on a contractual basis by the Corporation upon retirement and continue to receive discounts. Qualified employee discounts must be provided on a nondiscriminatory basis. See generally Regulations § 1.132-8. This regulation incorporates § 410(b) nondiscrimination standards, and the § 414(q) definition of HCE. See Regulations § 1.132-8(d) and (f).

Security-related Transportation

Regulations § 1.132-5(m)(1) provides that if a bona fide business-oriented security concern exists, and an overall security program exists, then the employee may exclude the excess of the value of the transportation provided by the employer over the amount that the employee would have paid for the same mode of transportation absent

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the bona fide security concern. With respect to air transportation, the phrase “same mode of transportation” means comparable air transportation.

The IRS wants to see that overall security program must be established. In order to establish the existence of an overall security program, the employer must generally establish that security is provided to the employee on a 24-hour basis.

An overall security program is deemed to exist if the following conditions are satisfied:

- A security study is performed with respect to the employer and the employee (or a similarly situated employee of the employer) by an independent security consultant;
- The security study is based on an objective assessment of all facts and circumstances;
- The recommendation of the security study is that an overall security program is not necessary and the recommendation is reasonable under the circumstances; and
- The employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.

An independent security study could conclude, for example, that security during air travel is necessary, but security on a 24-hour basis is unnecessary.

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Spousal/Dependent Life Insurance

Group term life insurance premiums paid to insure the lives of a spouse or dependent of an executive are included in the gross income of the owner.

Transportation

If a Corporation provides a car or other road vehicle, the amount excludable as a working condition fringe benefit is the amount that would be allowable as a deductible business expense if the individual paid for its use. The individual's personal use of the vehicle is taxable.

The value is generally determined by reference to fair market value unless one of the following three special valuation methods is used (Section 1.61-21(b)(4)):

1. Automobile lease valuation rule – Section 1.61-21(d)(2);
2. Vehicle cents-per-miles rule – Section 1.61-21(e); and
3. Commuting valuation rule – Section 1.61-21(f).

There are specific requirements that must be met in order to use these special valuation rules. For example, the employer must provide the employee with a vehicle for commuting for bona fide noncompensatory business reasons in order to use the commuting valuation rule.

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Chauffeurs

The taxable benefit with respect to a chauffeur is determined separately from the taxable benefit of the use of a vehicle. In order to determine the taxable benefit, the business use percentage must be determined.

Employer-paid parking

The term “qualified transportation fringe” (Section 132(f)) includes:

1. Transportation in a commuter highway vehicle between the executive’s residence and place of employment.
2. Any transit pass; and
3. Qualified parking.

The value of parking provided to an executive on or near the business premises of the employer is excludable from gross income if the statutory monthly limit is not exceeded (Section 132(f), 1.132-9, and Notice 94-3 (providing valuation rules)).

Transfer of Property

If a Corporation gives an owner property, that’s still considered a taxable transaction. It’s compensation just as if money was given. Property other than cash may be represented in a number of forms. It

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may include stock or personal property including real estate, furniture, equipment, personal computers and or cellular phones.

Employee Use of Listed Property

Special recordkeeping rules apply to computers except for those used exclusively at the business establishment and owned or leased by the person operating the business. Detailed records are required to establish business use of computers that can be taken home or are kept at home by the executives. There are no record keeping exceptions like "no personal use" available for computers.

Similar recordkeeping problems arise for cellular and car phones placed in service after 1989. Code Section 280F(d)(4)(A)(v) as adopted under OBRA '89 identifies these items as listed property. This requires documentation of business usage in order for the purchase and operational cost to be an allowable deduction and not included as income.

Relocation Expenses

The value of relocation benefits may be includable in gross income. Section 82 provides that there shall be included in gross income (as compensation for services) any amounts received as payment for or reimbursement of expenses of moving from one residence to another which is attributable to employment.

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However, Section 132(g) provides an exclusion for qualified moving expense reimbursements. Under Section 132(g), an employee may exclude the amount paid or reimbursed by the employer that would be deductible under Section 217.

Under Section 217, only the costs of moving personal belongings and traveling to the new location are deductible. Costs such as meals and lodging in temporary quarters are not deductible under Section 217. In addition, other costs paid by the employer, such as brokerage fees, property taxes, insurance, fix-up expenses, and reimbursement for losses with respect to the sale of the prior home are includable in gross income.

Non-commercial Air Travel

If an owner (or family member) uses the company's aircraft for personal reasons, the use must be valued and included in taxable wages. The value of the flight is determined by reference to fair market value unless the special valuation rules known as the Standard Industry Fare Level formula ("SIFL") are elected Section 1.61-21(g)(5)). There is a lower SIFL inclusion amount if the air travel is a security related benefit meeting the requirements of Section 1.132.5(m)(2)(iii).

Employer-paid vacations

The value of employer-provided vacations generally is includable in gross income and wages. The value of a vacation is generally not a tax free benefit because vacation expenses are personal expenses. A working

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condition fringe is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under Section 162 or 167 (Section 1.132-5(a)). In general no deduction shall be allowed under Section 162 for personal, living, and family expenses.

However, special rules exist for air travel provided in connection with trips that are part business and part personal. In addition, a portion of the cost of air travel may be excludable if there is a security related concern within the meaning of Section 1.132-5(m).

Spousal or Dependent Travel

No deduction under Section 274(m)(3) shall be allowed for travel expenses paid or incurred for a spouse, dependent, or other individual accompanying the executive on business travel unless:

- The spouse, dependent, or other individual is an employee of the taxpayer,
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose, and
- Such expenses would otherwise be deductible by the spouse, dependent, or other individual.

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Wealth Management

An owner may receive personal financial planning. The fee for this service, if paid by the C Corporation, needs to be included as part of the overall compensation. However, take a look at what can be paid and not be included. It's in the next section.

Qualified Retirement Planning

A C Corporation can provide qualified retirement planning services as a tax free fringe benefit. The services are defined in Section 132(m) as any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan.

The Corporation may not discriminate in favor of highly compensated executives. The nondiscrimination rule states that the exclusion is allowable for highly compensated employees only if the retirement planning services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified employer plan.

An Employer May Pay an Employee's Share of FICA Taxes

An employer may pay the FICA tax that may be due in respect to an employee's fringe benefit. The payment of the employee's FICA tax constitutes a payment of additional wages for FICA and income tax

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withholding purposes. (Yes, you've just created a circular equation. The Corporation pays the tax due on the fringe.) The payment of the tax is then subject to tax, which the Corporation can pay, which is then subject to the tax.

Stock Basis

Generally, basis in a C Corporation's stock will not change unless the shareholder acquires additional stock from another shareholder, through purchase or inheritance.

Corporate Liquidation/Dissolution

Probably the most complicated thing a C Corporation can do is quit business. In fact, without proper advance planning it can also be a very expensive thing to do.

Here are some of the things to consider when planning a C Corporation shut down.

References for Corporate Liquidations/Dissolutions

The references for Corporate Liquidations/Dissolutions are:

- IRC 302(b)(4) - Redemption from Noncorporate Shareholder in Partial Liquidation

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- IRC 331 - Gain or Loss to Shareholders in Corporate Liquidations
- IRC 332 - Complete Liquidations of Subsidiaries
- IRC 334 - Basis of Property Received in Liquidations
- IRC 336 - Gain or Loss Recognized on Property Distributed in Complete Liquidation
- IRC 338(h)(10) - Elective Recognition of Gain or Loss by Target Corporation
- IRC 346 - Definition and Special Rule - Complete Liquidation
- Rev. Proc. 90-52, 1990-2 C.B. 626
- Rev. Rul. 71-129, 1971-1 C.B. 397
- *Burnet v. Logan*, 283 U.S. 404 "1931 "
- *Arrowsmith v. Commissioner of Internal Revenue*, 344 U.S. 6
- IRM 4.61, Section 11 - Transfers of Property by and to Foreign Corporations

Overview for Corporate Liquidations/Dissolutions

A corporate liquidation should be considered at two levels: the shareholder level and the corporate level.

On the shareholder level, a complete liquidation can be thought of as a sale of all outstanding corporate stock held by the shareholders in exchange for all of the assets in that Corporation. Like any sale of stock, the shareholder receives capital gain treatment on the difference between the amount received by the shareholder in the distribution and the cost or other basis of the stock.

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At the corporate level, the Corporation recognizes gain or loss on the liquidation in an amount equal to the difference between the fair market value and the adjusted basis of the assets distributed.

If the Corporation is audited, the IRS agent will ask to see the plan of liquidation. Specifically, they are looking to make sure that the Corporation really was liquidated and wasn't a disguised attempt at tax avoidance through a reorganization.

Complete Liquidation

You might have heard the term "Complete Liquidation" before. Actually, this is a term that is not defined by the IRS Code. The regulations under Code Section 332 suggest that the status of liquidation exists when the Corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.

In Tax Court, we've seen a three-pronged test to determine whether a complete liquidation has taken place (see Joseph Olmstead v. Commissioner T.C. Memo 1984-381):

1. Was there a manifest intent to liquidate?
2. Was there a continuing purpose to terminate corporate affairs and dissolve?
3. Were the corporate activities directed and confined to that purpose?

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There are actually two parts to dissolving and liquidating a company. The dissolution is done under state law and is separate from the liquidating that is done under federal law, as mandated by the IRS. The IRS does not recognize dissolution under state law as controlling for federal tax purposes. Instead they are looking at intent combined with evidence of actual distributions to the shareholders.

Without a formal plan of liquidation, the exact date of when a liquidation occurred can get murky. The IRS has repeatedly stated that a Corporation in existence during any portion of a taxable year is required to file a return. So a Corporation that has been dissolved at the state level (or simply allowed to expire) and that has not been liquidated with the IRS, is still in existence. This can create a myriad of tax issues down the road.

A Corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law. It may thereafter be treated as continuing as a Corporation for certain limited purposes connected with winding up its affairs, such as for the purposes of suing and being sued. If the Corporation has valuable claims for which it will bring suit during this period, it has retained assets, and therefore continues to exist. A Corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it.

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Filing Requirements During Liquidation

The following list of items to complete for a liquidation is based on our experience with clients who were liquidating in the face of lawsuits and lists from the IRS audit procedures for liquidated companies.

- If assets are given to shareholders as part of the liquidation, the shareholders must be issued a Form 1099-DIV. The fair market value of the assets will show as the dividend amount.

- A Form 966, Corporate Dissolution or Liquidation, must be properly filed for a dissolved company. Refer to Rev. Proc. 90-52 for checklist questionnaires that may be applicable for the liquidation.

- The final return must be filed on or before the fifteenth day of the third full month following the dissolution.

- Additionally, the IRS will want to see that the following documents have been prepared for the Corporation that is liquidating:

- A resolution adopted by directors recommending corporate liquidation;

- A resolution adopted by shareholders approving the directors' recommendation;

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- A resolution adopted by directors authorizing the directors and officers to take all necessary steps to carry out the plan of complete liquidation;

- The plan of complete liquidation;

- The Corporation's final tax returns; and

- Statements furnished to shareholders detailing the fair market values of the assets that were distributed to the shareholders.

Shareholder's Gain or Loss Upon Liquidation

As a general rule, the fair market value of property received by a shareholder via a corporate liquidation, less the stock's adjusted basis represents the gain or loss to the shareholder. Remember that assumed liabilities will reduce the fair market value.

But, of course, like everything else when it comes to a C Corporation liquidation, gain or loss isn't always that simple. Some additional issues to consider:

1. **Timing of Loss Recognition by Shareholder.** When a shareholder receives a series of distributions in liquidation, gain is recognized once all of the shareholder's stock basis is recovered. A loss, however, will not be recognized until the final distribution is received [see Rev. Rul. 69-334, 1969-1 C.B.

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98, Rev. Rul. 68-348, 1968-2 C.B. 126, and Ethel M. Schmidt, 55 T.C. 335 (1970)].

2. **Unvalued Assets.** A taxpayer may advance the position that contingent contract rights/disputed claims/mineral royalties, etc., should not be recognized because an accurate valuation cannot be ascertained [see Burnet v. Logan, 283 U.S. 404 (1931)]. Look out! The IRS will then value the asset themselves.

3. **Distributions with Unknown Liabilities.** If the amount of a liability distributed is unknown at the time of distribution, or so speculative that it is properly disregarded in computing a shareholder's gain/loss on liquidation, any subsequent payment of the debt by the shareholder should be a capital and not an ordinary loss. This is based upon the theory that the original capital gain on the liquidation was overstated [see Arrowsmith, 344 U.S. 6 (1952)].

4. **Dividend income.** A dividend is defined in section 301. IRC section 331(b) holds that IRC section 301 will not apply to a liquidating distribution.

5. **IRS Section 1244 Stock Loss**. Code Section 1244 provides special rules. If stock qualifies as Code Section 1244 stock then the shareholder can claim an ordinary loss instead of a capital loss on the disposition or worthlessness of the stock. The requirements of Code Section 1244 stock are as follows:

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A. The stock was issued by a domestic Corporation which was a " small business Corporation" at the time the stock was issued;
B. The stock was issued by such Corporation for money or other property (other than stock and securities), and
C. The aggregate amount received for the stock was less then $1M; and
D. The Corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

For any taxable year the aggregate amount treated by the taxpayer as an ordinary loss pursuant to Code Section 1244 shall not exceed:

E. $50,000 or
F. $100,000, in the case of a husband and wife filing a joint return.

A qualifying C Corporation should include a note in its Organizational Resolutions that it is qualifying as a small business Corporation under Section 1244.

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Corporation's Gain or Loss

There could also be a gain that needs to be recognized at the C Corporation level. Remember that this gain is separate from what the individual shareholders will need to recognized. Possible issues include:

1. **Tax benefit Rule: Recapture of Prior Deductions.** There may be items of value not appearing in the asset accounts because they were expensed or written-off (e.g., small tools, cattle feed, supplies, etc.). To the extent that these items have a fair market value in excess of their adjusted basis, Code Section 336(a) gain would be recognized.

2. **Fair Market Value (FMV) of Assets.** Taxpayers often argue that book value approximates fair market value because tax depreciation is a measure of wear and tear on an asset. Often, a fully depreciated asset will have a higher fair market value than its book value. For instance, a fully depreciated luxury auto with a high resale value would have a higher fair market value. Generally speaking this gain will be recognized at the shareholder level.

3. **Liquidating Corporation Income.** Problems involving the amount of income a liquidating Corporation will report during the year of liquidation will frequently arise. Many cash-basis Corporations will have substantial accounts receivable, as in the case of professional Corporations. Although these receivables may not appear on the books, records of some type will exist to

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keep track of billings. If IRC section 336(a) does not serve as an argument that all of these receivables are taxable (as in the case where the fair market value of the billings is less than the face value of the receivables), then either the assignment of income or clear reflection of income doctrines should be advanced.

4. **Assignment of Income Doctrine.** This provides that the rights to receive income cannot be distributed to shareholders upon liquidation. Since the Corporation is the one that rendered the services for which customers were billed, then the receivables must be taxed to the Corporation [see J. Ungar Inc. v. Commissioner, 244 F.2d 90 (2nd Cir. 1957) and Williamson v. United States, 292 F.2d 524 (Ct. Cl., 1961)].

5. **Clear Reflection of Income Doctrine.** This argument maintains that in light of the requirement that an accounting method must clearly reflect income [IRC section 446(b)], an accounting method that is acceptable for a continuing business may not be allowable for a liquidating business. A Corporation that is on the completed contract method and liquidates when a project is only partially completed must include in income a percentage of the profit on the contract under the percentage completion method [Jud Plumbing & Heating, Inc., 153 F.2d 681 (5th Cir. 1946)].

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6. **Loss Recognition.** If there is a loss, the IRS is going to make sure that any assets being contributed by shareholders which result in losses aren't really a tax avoidance scheme to create losses. (The Government has been successful in establishing that such arrangements constitute a reorganization.

7. **Expense Accruals.** Any expense accruals should be recaptured as income if they are forgiven or not paid pursuant to the liquidation. This typically occurs with accruals of interest owed to commonly controlled entities.

Liquidation Expenses. Generally, the expenses incurred to liquidate a Corporation are deductible. The expenses of selling the assets are normally charged against the gain for each asset.

The following are exceptions to the general rules:

1. **Costs of Reorganization.** If the liquidation is related to a reorganization, the expenses allocated to the cost of the reorganization are not deductible.

2. **Liquidation Costs Paid by Shareholders.** If a shareholder incurs costs in effecting a complete or partial liquidation, the costs should be classified as capital expenditures. The costs will affect the shareholder's gain or loss upon liquidation.

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3. **Costs of Redeeming Stock.** Code Section 162(k) specifically provides that no deduction is allowed for any amount paid or incurred by a Corporation in connection with reacquisition of its stock.

4. **Expenses of Issuing/Reselling Stock.** A corporate taxpayer may generally write-off organization and merger expenditures that have been capitalized over the life of the Corporation, since they are considered worthless at the date of liquidation. However, the expenses of issuing or reselling stock are never deductible.

5. **Abandonment Losses on Intangibles.** A Corporation will frequently claim abandonment losses on intangibles, such as leasehold costs and trademarks, upon liquidation. If the likelihood exists that the items will be used after liquidation, then the assets are not considered worthless and no IRC section 165 loss is available.

The above has focused on the liquidation at the federal level. The state dissolution varies by state. For more information on your particular state dissolution, please reference the state's website and/or visit us at the USTaxAid forum.

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Filing Your C Corporation Tax Return Conclusion

The C Corporation has been around a long time. And that means there is a lot of case law that has been built up over time. That has its good points and its bad. On the helpful side for you, it means you know what works and what doesn't. And on the, better watch out side, it means that the IRS knows what works and what doesn't.

Unfortunately, seminar promoters who are more interested in selling a Corporation then helping a client have talked some people into setting up C Corporations with little or no guidance. As a result, there can be trouble come tax time and especially in closing down the Corporations properly.

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