CLOSELY-HELD CORPORATIONS

2014 CPE TAX EXPO

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CLOSELY-HELD CORPORATIONS

PART 1:
CHOICE OF ENTITY

I. Major Factors

A. **Traditional Factors** - The traditional factors for the determination of whether to incorporate or not have generally been centered around variations of the following concepts: (i) liability exposure, (ii) capital formation, (iii) management and (iv) continuity of life. These traditional factors work well when dealing with large, publicly traded corporations, where it is desirable to form an entity that has (i) limited liability on the behalf of its owners, who generally are not active in the business of the entity ("liability exposure"), (ii) marketable units (shares of stock) for raising capital to conduct business operations ("capital formation"), (iii) centralized management by a smaller body (the board of directors) than the large number of owners ("management") and (iv) perpetual duration ("continuity of life").

B. **Closely-Held Corporations** - On the other hand, while other issues may play a part in the choice of entity determination, in the closely-held business scenario, the major factors almost inevitably revolve around (i) limited liability and (ii) achieving similar U.S. tax consequences to a sole proprietorship or partnership by avoiding double taxation and/or obtaining pass-through of tax losses.

II. Other Limited Liability Entities

A. **Professional Service Organizations**

1. Professional Corporations – Texas Business Organizations Code ("TBOC") Chapters 301 and 303

Professions included: accountants, acupuncturists, athletic trainers, attorneys, audiologists, chiropractors, clinical social worker, dentists, insurance agents, licensed insurance adjusters, licensed family therapists, licensed marriage therapists, licensed master social worker, licensed professional counselors, message therapists, medical radiologic technologists, nurses (advanced practice nurses, nurse anesthetists and nurse practitioners), occupational therapists, optometrists, orthotists, paramedics, physical therapists, physician assistants, podiatrists, professional sanitarian, prosthetists, psychologists, respiratory care therapists, speech pathologists and veterinarians.

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Professions excluded: physicians, surgeons, other medical doctors, engineers, architects, pubic surveyors, cosmetologists, dieticians, mortgage brokers, pharmacists, private security investigators, securities brokers/dealers, real estate agents/brokers, interior designers, court reporters, patent agents, educational diagnosticians, registered lobbyists, social workers and enrolled agents

Certified Public Accountants: A public accounting firm that is to have owners who are not certified public accountants would form a business corporation. A public accounting firm that is to be owned solely by certified public accountants would form a professional corporation.

Insurance agents may form either a professional corporation or a business corporation.

Podiatrists, dentists, chiropractors, optometrists, psychologists, licensed professional counselors, licensed family therapists, licensed marriage therapists and veterinarians may form either a professional corporation or a professional association.

2. Professional Associations – TBOC Chapters 301 and 302 – physicians and surgeons

B. **Limited Partnerships** – TBOC Chapters 151 and 153

C. **Limited Liability Companies** – TBOC Chapter 101

D. **Limited Liability Partnerships** – TBOC §§152.801 – 152.913

PART II.
ORGANIZATION OF CORPORATION

I. Legal and Tax Documents:

A. Certificate of Formation (post-TBOC); Articles of Incorporation (pre-TOBC); Bylaws; Organizational Minutes; Stock Certificates; Assumed Name Certificates (if applicable); Form SS-4, Application for Employer Identification Number; Form 2553, Election by a Small Business Corporation (if S Corporation status desired); Form 8264, Application for Registration of a Tax Shelter (if tax shelter under IRC §6111).

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B. Assumed Name Certificates and Certificates of Authority

1. Assumed Names - Any corporation which regularly conducts business under an assumed name shall file an Assumed Name Certificate in the office of the Secretary of State and in the office of (i) the county clerk of the county in which such corporation's registered office is located and (ii) the county in which its principal office is located if different from the county where the registered office is located. VATS Business and Commerce Code, Vol. 4. §36.11. A corporation conducting business under an assumed name which intentionally violates a provision of the Assumed Name statutes is guilty of a misdemeanor and upon conviction shall be punished by a fine not exceeding $2,000.00. VATS Business and Commerce Code, Vol. 4 §36.26.

2. Foreign Corporations - A foreign corporation which is transacting or has transacted business in Texas without a filed Application for Registration (post-TBOC) or a filed Certificate of Authority (pre-TBOC) may not maintain any action or proceeding in any court in Texas on any cause of action arising out of its transaction of business in Texas, until such corporation shall have filed an Application for Registration. TBOC §9.051(b). A corporation that has transacted business in Texas without an Application for Registration (post-TBOC) or a Certificate of Authority (pre-TBOC) shall pay all taxes and other penalties that would have been owed if properly registered and all penalties and interest on such amounts. TBOC §9.052.

II. Control

A. General Control Source

1. Shareholders – The shareholders of a corporation (the owners) have very limited powers under the general structure of the TBOC and/or the Texas Business Corporations Act ("TBCA"). Among the limited actions that the shareholders may vote on are (i) the election of directors (TBOC §21.405 or TBCA Art. 2.32); (ii) amendment of Certificate of Formation (post-TBOC) (TBOC §21.054 – however, directors must adopt resolution first) or amendment of Articles of Incorporation (pre-TBOC) (TBCA Art. 4.02 – again, directors must adopt a resolution first); (iii) reduction of stated capital without amendment of Certificate of Formation or Articles of Incorporation and without cancellation of shares (TBOC §21.253 or TBCA Art. 4.12 – however, directors must adopt a resolution first); (iv) approval of merger, consolidation or conversion of the corporation (TBOC §21.452 (merger) and TBOC §21.453 (conversion) or TBCA Art. 5.03.A – however, the directors must adopt a resolution first); (v) consent to a sale, lease, exchange or other disposition (not including any pledge, mortgage or deed of trust) of all, or substantially

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all, the property and assets of the corporation (TBOC §21.455 or TBCA Art. 5.10 – however, the directors must pass a resolution first); (vi) voluntary dissolution by shareholders (TBOC §21.502(1) or TBCA Art. 6.02 – unilateral written consent of all shareholders or TBOC §21.503(3) or TBCA Art. 6.03 – less than unanimous vote of shareholders and directors must adopt a resolution first).

2. Directors – The business and affairs of a corporation shall be managed by the Board of Directors. TBOC §21.401 or TBCA Art. 2.31.

3. Officers – Officers manage the corporation in accordance with directives established under the Bylaws or by the Board of Directors. TBOC §3.103 or TBCA Art. 2.42.B.

B. Protection of Control at Shareholder Level

1. Election of Directors

   a. Preemptive rights (TBOC §21.203 or TBCA Art. 2.22-1) – if represent majority interest, deny shareholders' preemptive rights. If represent minority interest, provide for shareholders' preemptive rights in the Certificate of Formation (post-TBOC) or in the Articles of Incorporation (pre-TBOC). If Certificate of Formation (post-TBOC) or Articles of Incorporation (pre-TBOC) are silent, preemptive rights are denied.

   b. Cumulative Voting (TBOC §21.360 or TBCA Art. 2.29.D.) – if represent majority interest, cumulative voting should be denied. If represent minority interest, provide for cumulative voting in the Certificate of Formation (post-TBOC) or in the Articles of Incorporation (pre-TBOC). If the Certificate of Formation (post-TBOC) or the Articles of Incorporation (pre-TBOC) are silent, cumulative voting is not allowed. Please note that any shareholder who intends to cumulate his vote at any meeting of the shareholders must give written notice of such intention to the secretary of the corporation on or before the day preceding such meeting. TBOC §21.361(b) or TBCA Art. 2.29.D.(2).

   c. High quorum or voting requirements in the Certificate of Formation (post-TBOC) or the Articles of Incorporation (pre-TBOC).

   d. For corporations still governed under the TBCA, a shareholders agreement restricting transferability of shares in order to be able to "lock-in" shareholder group that votes on selection of directors (protection of "clique").

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   e. For corporations governed under the TBOC, a shareholders agreement under TBOC §21.101.

2. Voting Trusts and Voting Agreements – Any number of shareholders may create a voting trust or enter into a voting agreement by which they may vote their shares as a unit. For corporations still governed under the TBCA, voting trusts and voting agreements presumably only allow control of voting matters within the domain of the shareholders, not voting on management powers within the domain of the directors. TBCA Art. 2.30. For corporations governed under the TBOC, this can be effected through a TBOC §21.101 shareholders agreement that can delegate management powers to the shareholders.

3. Pre-TBOC Corporations/Limitation of Directors and Officers Powers in Articles of Incorporation (TBCA Art. 2.02.B.) – Provides possibility of limiting powers of directors and officers within the Articles of Incorporation, with presumable result of increasing powers of shareholders. May even allow management power provisions by shareholders often contained in Shareholders' Agreement if provided in Articles of Incorporation.

4. Pre-TBOC Corporations/Close Corporation – TBCA Part 12

   a. Management – by (i) Board of Directors like ordinary corporation or (ii) in accordance with Articles of Incorporation or Shareholders' Agreement. TBCA Art. 12.31.

   b. Shareholders' Agreement – provides for broad range of matters to be governed thereunder, including management by the shareholders. TBCA Art. 12.32.

   c. Statement of Operation – required to be filed if business of close corporation conducted pursuant to Shareholders' Agreement. TBCA Art. 12.34.

   d. Shareholder Liability – no shareholder liability due to lack of corporate formalities. TBCA Art. 12.37.F. If management by shareholders pursuant to Shareholders' Agreement, shareholders treated as directors of regular corporation for liability purposes. TBCA Art. 12.37.C.

5. Pre-TBOC Corporations/TBCA Art. 2.30-1 Shareholders Agreements (effective 9-1-97).

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6. Post-TBOC Corporations/§21.101 Shareholder Agreements (TBOC §§21.101 – §21.109) or TBOC Close Corporation provisions (TBOC §§21.701 – 21.732).

C. Non-Management Shareholder Agreement Provisions

1. Restriction on transferability of stock interest through right of first refusal or through required consent.

2. Obligate the corporation or the other shareholders to purchase the stock shares upon the happening of certain events such as death, disability or other withdrawal of a stockholder. Creates market for withdrawing stockholder. Or, provide repurchase rights in the form of an option.

III. Stock Issuance

A. Types of Stock

1. Common – Voting or Nonvoting.

2. Preferred Stock – preferences in liquidation and/or dividends, convertible or non-convertible, participating or nonparticipating, cumulative or non-cumulative.

B. **Use of Preferred Stock in Recapitalization** – IRC Chapter 14 (§§2701-2704) substantially limits the tax benefits of shifting the appreciation component of a business interest from the senior generation to a junior generation in closely-held family businesses through use of preferred stock.

IV. Tax Considerations Upon Incorporation

A. §1244 Stock

1. Loss from sale or exchange of §1244 Stock will be treated as ordinary loss (as opposed to capital loss) to the extent of $50,000.00 per single taxpayer or $100,000.00 for husband and wife filing a joint return.

2. Corporation must be a "small business corporation", meaning aggregate amount of money and other property received by corporation *for stock*, as a contribution to capital, does not exceed $1 million.

3. Stock must be issued for money or other property. §1244(c).

4. Such corporation, during the period of its five most recent taxable years ended before the date of loss, derived more than 50% of its aggregate gross income from sources other than passive income sources.

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5. Does not need to be formally elected, but usually a provision is provided in the Organizational Minutes or Bylaws.

B. S Corporation Election

1. Good mechanism for avoiding taxation during operating years of corporation.

2. S Corporation is a small business corporation which does not have (i) more than 100 shareholders, (ii) a shareholder who is not an individual (although some special types of trusts may qualify), (iii) a nonresident alien as a shareholder or (iv) more than one class of stock.

3. "Safe harbor debt" means a written note payable on demand or on a specified date if the interest rate is not contingent on profits, the borrower's discretion or similar factors, there is no convertibility into equity and the creditor is an individual (other than a nonresident alien). If do not meet safe harbor debt requirements, such debt may be reclassified as equity in the form of a second class of stock (liquidation preference) resulting in the disqualification of the corporation as an S Corporation.

4. Basis limitation on pass through of losses (IRC §1366(d)) – the aggregate amount of losses and deduction shall not exceed the shareholder's basis in its stock or any indebtedness of the S Corporation to the shareholder. See, *Kerzner v. Commissioner*, T.C. Memo 2009-76 (4/6/09), holding that shareholders received no basis from direct loans from the shareholders to their S Corporation because, under the fact pattern, the shareholders made no true economic outlay even though there was a direct indebtedness to the shareholders. The shareholders had received the funds from an affiliated entity that had borrowed the funds from a third party and the shareholders were not primarily obligated to repay the borrowed amount. The court ruled that the circular flow of funds created no true economic outlay by the shareholders and, thus, no basis increase was created for pass-through of losses from the S Corporation. *But see* proposed IRS rules (REG-134042-07), 77 Fed. Reg. 34884 (6/12/12), which would allow an increase in shareholder's basis if the indebtedness of the S corporation to the shareholder is bona fide.

5. 1986 Tax Reform Act – The 1986 Tax Act contained significant provisions affecting the ability of a regular corporation to elect S Corporation status to avoid the new corporate level upon liquidation. Under the 1986 Tax Reform Act, S Corporations will pay tax on any gain that arose prior to its conversion to S status that it recognizes through a sale or distribution within ten (10) years after the date the S election was effected. [Note that in the case of any taxable year

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beginning in 2009 or 2010, no tax is imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year (i.e., the recognition period is temporarily shortened to seven years). §1374(d)(7), *as amended by* 2009 ARRA, P.L. 111-5, §1251(a).] Special rules provide that the S Corporation will not pay tax to the extent it can show the appreciation occurred after its change to S status; thus, appraisal of assets at time of conversion may be advisable. Sales of property acquired pursuant to a taxable purchase of property after the conversion will not be subject to this tax. Caveat for personal service C Corporations on cash basis converting to S Corporation: IRS will take the view that accounts receivable are appreciated assets for §1374 tax. IRS Ann. 86-128, IRB 1986-51. In addition, an S Corporation is allowed to offset any gain with its unexpired attributes from its prior C Corporation status, such as unexpired net operating losses. These rules apply to S elections made after December 31, 1986.

C. **Transfer of Property to Corporation** – Generally, under §351 no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and immediately after the exchange such person or persons own 80% of the stock of the corporation. However, be careful of IRC §357(c), which provides that a shareholder will recognize income to the extent liabilities exceed basis on property contributed to a corporation.

D. **Debt to Equity Ratio – IRC §385**

1. Corporate indebtedness to its stockholders must be carefully structured so that repayments of purported debt obligations are not treated as taxable dividends.

2. Retracted IRC §385 Regulations provided for 3:1 insider "debt to equity" ratio and 10:1 outsider "debt to equity" ratios.

3. Term of purported loan document and comparison of payment and interest provisions compared to commercial norms are important factors.

E. **Amortization of Organization Costs – IRC §248**

F. **Use of Multiple Corporations and Election to File Consolidated Return**

1. Protection of assets in separate corporate entities. In *SSP Partners v. Gladstrong Investments (USA) Corporation*, 52 Tex. Sup. Ct. J. 95 (Nov. 14, 2008), the Texas Supreme Court clarified that "the single business enterprise theory" is **not** a means to impose one corporation's liabilities on another and rejected the theory as inconsistent with veil piercing principles under Texas law.

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Old law: A 1986 case, *Paramount Petroleum Corp. v. Taylor Rental Center*. 712 S.W.2d 534 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.), provided credence that the single business enterprise theory could be used to pierce the corporate veil under Texas law. There the court stated:

> [W]hen corporations are not operated as separate entities but rather integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for debts incurred in pursuit of that business purpose. Factors to be considered in determining whether the constituent corporations have not been maintained as separate entities include but are not limited to the following: common employees; common offices; centralized accounting; payment of wages by one corporation to another corporation's employees; common business name; services rendered by the employees of one corporation on behalf of another corporation; undocumented transfers of funds between corporations; and unclear allocation of profits and losses between corporations.

New law: The Texas Supreme Court rejected the *Paramount* decision stating:

> Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances. There must also be evidence of abuse, or as we said in *Castleberry*, injustice and inequity. By "injustice" and "inequity" we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield — fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity. Any other rule would seriously compromise what we have called a "bedrock principle of corporate law" — that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's obligations'… Accordingly, we hold that the single

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business enterprise liability theory set out in *Paramount Petroleum* will not support the imposition of one corporation's obligations on another.

2. Offset income from "income" affiliates with that of "loss" affiliates.

G. Midstream Incorporation of Cash Basis Business

1. Accounts receivable of a cash-basis transferor – although unclear, reasonable basis exists for treating accounts receivable as taxable to corporation rather than transferor.

2. Accounts payable – also unclear, best strategy to pay all accounts payable prior to incorporation; however, considerable leeway on deductibility of accounts payable between transferor and transferee corporation.

3. Incorporation of partnership business – Rev. Rul. 84-111 dictates tax consequences of three methods of incorporating an existing partnership.

H. Texas Franchise Tax

Effective generally for tax years commencing with 2007, the existing Texas franchise tax was replaced with a new tax (referred to as the "Texas Margins Tax") that applies to most business entities that have statutory liability protection, including, without limitation, corporations (C or S), limited liability companies and limited partnerships. The Texas Margins Tax is generally a 1% (0.5% for retailers and wholesalers) tax levied on "taxable margin" (though temporary rate reductions are available for tax years 2014 and 2015 under 2013 legislation enacted through HB 500). "Taxable margin" for this purpose is generally equal to total revenue of the entity, less deductions for either (1) cost of goods sold or (2) compensation, including benefits. Compensation (excluding benefits) is limited to $300,000 per person (inflation adjusted every two years). Under a 2007 legislative amendment (HB 3928), a 0.575% gross receipts tax may be used as an alternative tax for entities with $10 million or less in total revenue.

Limited partnerships, including family limited partnerships, that meet certain qualifications making them "passive entities" are exempt from this tax. Additionally, otherwise taxable entities with gross receipts of $300,000 or less (inflation adjusted every two years) are also exempt from this tax for tax years prior to 2010. Under a 2007 legislative amendment (HB 3928), entities with gross receipts from $300,001 to $900,000 will receive a discount on the tax based on a sliding scale for tax years prior to 2010. Starting with a 2009 legislative amendment (HB 4765), the small business exemption was again increased so that otherwise taxable entities with gross receipts of $1,000,000 or

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less would be exempt from this tax. HB 500 enacted in 2013 makes the $1,000,000 exemption (with adjustment for inflation) permanent. However, affiliated entities deemed to constitute a unitary business are required to do combined reporting, which, among other things, may disqualify various affiliated entities from use of the applicable small business exemption.

V. Securities Law Issues.

A. Regulation D

1. Rule 501 – Definitions

   a. Accredited investor.
   b. Issuer.
   c. Purchaser representative.

2. Rule 502 – General Conditions

   a. Disclosure requirements.
   b. Limitation on manner of offering (no public advertisement).
   c. Limitations on resale.

3. Rule 503 – Filing of Notice of Sale

4. Rule 504 – Small Sales (not exceeding $1 million) Subject to State Regulation

5. Rule 505 – Offerings not exceeding $5 million

   a. Number of non-accredited purchasers may not exceed 35.

6. Rule 506 – Offers Without Regard to Dollar Amount

   a. Purchasers limited to 35 non-accredited investors and an unlimited number of accredited investors.

   b. Sophistication requirements as to purchasers.

B. Texas Limited Offering Exemptions

1. Rule 109.13 – Purchase of securities by investors who are not well informed and sophisticated constitutes "public solicitation" under Texas law.

2. Uniform Limited Offering Exemption – No commission may be paid for sale of securities.

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VI. Use of Same Name – VATS Art. 1302-2.02 requires that whenever any unincorporated business becomes incorporated without a change of its firm name, such firm shall give notice of dissolution and publish in a newspaper (in the county in which the firm has its principal business office) for at least four consecutive weeks a notice of its intention to become incorporated. Until such notice has been published for the full period, no change shall take place in the liability of such firm or the members thereof to those dealing with the firm or its member.

PART III: BUSINESS OPERATIONS OF CORPORATION

I. Reasonable Compensation

A. **Statutory Rules** – IRC §162(a) provides there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade of business, including "(1) a reasonable allowance for salaries or other compensation or for personal services actually rendered."

B. **Treasury Regulations** – Reg. §§1.162-7 and 1.162-9

C. **Weight Factors Taken From Court Decisions**

1. The matter of reasonable compensation is a question to be resolved on the basis of an examination of all the particular facts and circumstances of each individual case. *Mayson Manufacturing Co. v. Comm.*, 49-2 USTC Par. 9467; *Home Interiors and Gifts, Inc. v. Comm.*, 73 TC 1142 (1980).

2. The determination of what constitutes reasonable compensation for personal services actually rendered is not a matter of exact mathematical or other science, but is, rather, a matter of individual judgment. *Hamilton & Co., Inv. v. Comm.*, 18 TCM 1959-153.

3. The courts are reluctant to substitute their own judgment for that of the employer-taxpayer's management, whether such judgment be in the form of a corporate resolution authorized by the corporation's board of directors or whether, in the case of closely held corporations where the officer-employees involved are also the board members, in the form of a year-end decision made during informal meetings of the officers involved. *Gordy Tire Co. v. US*, 62-1 USTC Par. 9119; *Woodcliff Silk Mills*, 1 BTA 715 (1925); *Standard Silk Dyeing Co. v. Comm.*, 9 BTA 648 (1927).

4. The Commissioner's proposed disallowance of any ordinary and necessary expense deduction set out in a determination letter carried the

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presumption of correctness in a litigated case. However, once the taxpayer has introduced any credible and competent evidence to rebut the Commissioner's actions, the presumption of correctness will no longer prevail, and the court's determination must then be made on the basis of the preponderance of the evidence. *Gordy Tire Company v. U.S.*, 62-1 USTC Par. 9119; *Hamilton & Co., Inc. v. Comm.*, 18 TCM 1959-153.

5. The mere size of the salary or other compensation cannot, under the law, be determinative of the reasonableness of compensation for personal services rendered. *William S. Gray & Co. v. U.S.*, 39-2 USTC Par. 9526-A; *Helen L. Foos v. Comm.*, 41 TCM 1981-61; *Home Interiors and Gifts, Inc. v. Comm.*, 73 TC 1142 (1980).

6. The policy of paying sums in the nature of a bonus after they are earned is based upon sound business principles. *William S. Gray & Co. v. U.S.*, 39-2 USTC Par. 9526-A; *Mayson Manufacturing Co. v. Comm.*, 49-2 USTC Par. 9467.

7. What may be reasonable compensation, and therefore deductible as an ordinary and necessary expense, may vary from year-to-year in the same corporation, or as between different corporations engaged in the same business, in the same location, and practically under the same management; it being in the end controlled by the human element involved. *William S. Gray & Co. v. U.S.*, 39-2 USTC Par. 9526-A; *H.V. Greene Co. v. Comm.*, 5 BTA (1926); *F.J. Ross & Co., Inc. v. Comm.*, 7 BTA (1927).

8. When the evidence shows that the employer-taxpayer's success is primarily attributable to the personal efforts of the officer-employee in question, it is difficult to support a finding that compensation payments to that officer are unreasonable. *Eduardo Catalano, Inc. v. Comm.*, 38 TCM 1979-183, *Home Interiors and Gifts, Inc. v. Comm.*, 73 TC 1142 (1980).

9. The concept of reasonable compensation must take into consideration the effects of inflation. *Home Interiors and Gifts, Inc. v. Comm.*, 73 TC 1142 (1980).

10. The relative weight of the dividend history of the taxpayer-corporation is small as compared to the importance of the value of the services performed by the employee in question. In fact, at least one court has gone so far as to state that if compensation is otherwise reasonable, whether dividends were paid is immaterial. *Paramount Clothing Co., Inc. v. Comm.*, 38 TCM 1979-64; *Ledford Construction Co., Inc. v. Comm.*, 36 TCM 1977-204; *Webster Tool & Dye, Inc. v. Comm.*, TC Memo 1985-604.

11. A deduction for reasonable compensation is not limited to amounts paid as compensation for services rendered in current years. Payments made by an employer to an employee may be deductible as reasonable compensation for current and past services rendered. *R. J. Nicoll Co. v. Comm.*, 59 TC 37 (1972); *Auburn & Assoc., Inv. v. U.S.*, 72-1 USTC Par. 9170; *Henry Shotmeyer v. Comm.*, 40 TCM 1980-238.

12. A personal service corporation may deduct essentially all of its net profits as reasonable compensation. *Helen L. Foos v. Comm.*, 41 TCM 1981-61.

13. An important consideration in non-personal service corporation situations is whether, after the compensation deduction, the corporation has sufficient retained earnings to represent a reasonable return on its capital stock. *Klug & Smith Co. v. Comm.*, 18 BTA 966 (1930).

14. The most important consideration in reasonable compensation cases is the value or worth of the employee's services to the employer. *William S. Gray v. Comm.*, 39-2 USTC Par. 9526-A.

D. S Corporation Election is good tax planning device to avoid IRS challenges to the deductibility of compensation to shareholder employees.

However, watch out for payroll tax issues as the IRS may assert that compensation to shareholder employees may be too low, resulting in a recharacterization of shareholder distributions as wages and, accordingly, tax assessments for payroll taxes (FICA, Medicare, FUTA), penalties and interest. *See e.g.*, *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (2004-1 USTC Para. 50,138) (93 AFTR2d 2004-608) (2004, CA-3); *See also*, IRM 4.35.2.5.2.2 which cautions IRS examiners to "[B]e aware of inadequate salaries paid to officer/shareholders who receive substantial nontaxable distributions. S corporation earnings are not subject to the self-employment tax, so officer/shareholders often receive small or no salary income to avoid employment taxes".

Perhaps a relatively recent case can be instructive in this area: *David E. Watson PC* v. U.S. No. 11-1589 (8th Cir. 2/21/12). The taxpayer in this case, an experienced CPA working full time for his S corporation firm, reported (i) $24,000 as "W-2" compensation income and $203,651 as Schedule E income for tax year 2002 and (ii) $24,000 as "W-2" compensation income and $175,470 as Schedule E income for tax year 2003. The Eighth Circuit held that "W-2" compensation should have been $91,044, subject to payroll taxes, for each year.

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Additionally, as the S corporation may be increasingly utilized to avoid the new 3.8% net investment tax and the 0.9% additional Medicare tax, increased scrutiny by the IRS on whether S corporation wages are too low can be anticipated.

II. Accumulated Earnings Tax

A. Statutory Rules

1. §531 – Imposition of Accumulated Earnings Tax
2. §532 – Corporations Subject to Accumulated Earnings Tax
3. §533 – Evidence of Purpose to Avoid Income Tax
4. §534 - Burden of Proof
5. §535 – Accumulated Taxable Income
6. §536 – Income Not Placed on Annual Basis
7. §537 – Reasonable Needs of the Business

B. Imposition and Rate of Tax (§531)

1. In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income of every subject corporation, an accumulated earnings tax (AET) equal to the sum of –

   a. 27-1/2 percent of the accumulated taxable income not in excess of $100,000, plus
   b. 38-1/2 percent of the accumulated taxable income in excess of $100,000.

C. Corporations Covered (§532)

1. AET imposed on every corporation (other than those described below) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being paid out as dividends or otherwise distributed. IRC §532(a).

2. Exceptions (§532(b)).

   a. A personal holding company (§542).
   b. A foreign personal holding company (§552).
   c. A corporation exempt from tax (§501 et. seq.).
   d. S Corporations (§1361 et. seq.) because S Corporations are deemed to have distributed all earnings.

3. Number of shareholders irrelevant (Tax Reform Act 1984).

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D. Corporate Motive (§533)

1. The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence, shall prove to the contrary.

2. Corporation being a mere holding or investment company shall be prima facie evidence of an income tax avoidance motive.

E. Burden of Proof (§534)

1. In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall be:

   a. If notification described below has not been sent, on the Secretary, or
   b. If the taxpayer has submitted the statement described below, on the Secretary.

2. Notification by Secretary - Before mailing the notice of deficiency, the Secretary may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by §531.

3. Statement by Taxpayer - Within 60 days after the mailing of the Secretary's notification (Reg. §1.534-2(d)(2)), the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

F. Accumulated Taxable Income (§535)

1. Accumulated taxable income equals taxable income with the adjustments provided in §535(b), minus the sum of the dividends paid deduction and the accumulated earnings credit. The major adjustments are as follows:

   a. A deduction for federal income taxes;
   b. A deduction for charitable contributions in full;
   c. The net operating loss deduction is not allowed;

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d. Generally, a deduction is allowed in full for capital losses;
e. A deduction for the net capital gain for the taxable year reduced by income taxes attributable to such gain.

2. Accumulated Earnings Credit – The greater of the (i) amount of the minimum credit (generally $250,000 for most corporations, or $150,000 for certain service corporations) or (ii) the accumulated surplus retained for the reasonable needs of the business.

G. **No Requirement to Annualize Income (§536)** – there is no requirement to annualize the taxable income for short periods.

H. **Reasonable Needs of the Business (§537)**

1. The term "reasonable needs of the business" includes –

a. The reasonably anticipated needs of the business;
b. §303 redemption needs of the business; and
c. The excess business holdings redemption needs of the business.

2. Reg. §1.537-2(b) provides that the following are examples of reasonable needs of the business:

a. To provide for bona fide expansion of business or replacement of plant;
b. To acquire a business enterprise through purchasing stock or assets;
c. To provide for the retirement of bona fide indebtedness created in connection with the trade or business;
d. To provide necessary working capital for the business, such as, for procurement of inventories;
e. To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or
f. To provide for payment of reasonably anticipated product liability losses.

3. Reg. §1.537-2(c) provides that the following are signs of possible unreasonable accumulations:

a. Loans to shareholders;
b. Loans to others having no reasonable relationship to the business;
c. Loans to affiliated corporations;
d. Investment in properties or securities unrelated to the business; or
e. Retention of funds to provide against unrealistic hazards.

4. Working Capital Needs - Case Law Formula

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a. "Bardahl Formula" – *Bardahl Manufacturing Corporation v. Comm.* 24 TCM 1030 (1965).

(1) Provide mathematical formula for determining the length of the corporation's ordinary operating cycle and the amount of working capital needed to operate the business for one full cycle.

(2) Inventory cycle:
Inventory Amount/Cost of Goods Sold = Decimal part of year inventory cycle

(3) Receivable cycle:

Receivable Amount/Net Sales = Decimal part of year of receivable cycle

(4) Operating cycle for the corporation in the <u>sum</u> of (2) and (3) above.

(5) Decimal in (4) times <u>"costs of operation"</u> plus <u>"costs of good sold"</u> for year = "Working capital need."

b. Formula modified for services businesses.

III. Compliance With Corporate Formalities

A. Shareholder's Meeting – TBOC §21.351 and TBCA Art. 2.24.B. states that "an annual meeting of the shareholders <u>shall</u> be held at such time as may be stated in or fixed in accordance with the bylaws."

B. Directors – The business of a corporation shall be managed by a Board of Directors. TBOC §21.401 and TBCA Art. 2.31. TBOC §21.411 and TBCA Art. 2.37 provides for regular and special meetings of the Board of Directors.

C. Prior to September 1, 1997, TBCA Art. 2.21 provided for a liability shield against only contractual (as opposed to tort) obligations of the corporation based on the failure of the corporation to observe a corporate formality. Effective September 1, 1997, TBCA Art. 2.21 was amended to provide a liability shield for all obligations (including both contractual and tort liabilities) based on the failure of the corporation to observe a corporate formality. The statute does not provide for protection against *tort* liabilities under piercing the corporate veil theories such as alter ego, actual or constructive fraud, sham to perpetuate a fraud and similar theories. TBOC §21.223(a)(3) provides the same rules for corporations governed by the TBOC.

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PART IV:
TERMINATION OF CORPORATION

I. U.S. Income Tax Liquidation

A. IRC §331 – Amount received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as received in full payment in exchange for stock, resulting in capital gain treatment. File Forms 966 and 1099.

B. IRC §333 – One month liquidation repealed by 1986 Tax Reform Act.

C. IRC §336 – Under Tax Reform Act of 1986, tax rules were dramatically changed with respect to gain or loss recognized by liquidating corporation or appreciated property distributed in complete liquidation. Generally, gain or loss shall be recognized to the liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

II. State Law Dissolution

A. Certificate of Termination (post-TBOC) or Articles of Dissolution (pre-TBOC) – to be filed with the Secretary of State. TBOC Chapter 11 or TBCA Part VI.

B. Shareholders Resolutions – authorizing Plan of Liquidation.

C. Directors Resolutions – authorizing Plan of Liquidation.

D. Unanimous Written Consent of Shareholder to Plan of Liquidation.

E. Secretary's Certificate of Approved Plan of Liquidation to be filed with Form 966.

F. Comptroller's Certificate of Good Standing for dissolution and merger purposes.

G. Send notice of dissolution to all creditors. TBCA Art. 6.04.A.(2). No TBOC provision.

III. Asset Protection Through Dissolving Corporations

TBOC §11.356 and TBCA Art. 7.12 provide that all claims against a dissolved corporation expire after three years, if such claims are not brought within such time period. This could shorten the period of time a creditor may have to seek remedies against a corporate defendant, if the applicable statute of limitations for such claim

exceeds three years or if the cause giving rise to such action is discovered later and no proceeding is filed within such three year period.

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