6-25-2004

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Removing Assets from a C Corporation

— by Neil E. Harl*

The shift in income tax rates on dividends¹ and long-term capital gains² has created useful options for removing assets from C corporations where taxpayers have been reluctant to incur the tax burdens of corporate liquidation.¹ The fact that both provisions sunset after 2008,¹ and could conceivably disappear before 2009 under fiscal pressure, suggest that a review of available options would be timely.

**History of the problem**

Prior to enactment of the Tax Reform Act of 1986,³ liquidation of C and S corporations could be carried out largely or totally income tax free.⁴ The 1986 Act eliminated the corporate liquidation options previously available under which a corporation could adopt a plan of complete liquidation, distribute the assets within a 12-month period and avoid gain or loss at the corporate level (except for various recapture consequences).⁵ The 1986 Act allowed eligible closely-held corporations to use prior law provisions for liquidating sales and distributions occurring before January 1, 1989, if the liquidation was completed before that date.⁶

Since 1988, all C corporations have been subject to uniform rules under which gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation as if the property were sold to the distributee at its fair market value.⁷ In addition, on complete liquidation, a shareholder recognizes gain or loss to the extent of the difference between the value of property received and the income tax basis of the stock given up, regardless of the form in which the distribution is received.⁸

For S corporations, no gain or loss is normally recognized at the corporate level unless the “built-in gains” tax applies;¹¹ The built-in gains tax applies to taxable years after 1986 on sales or exchanges of assets (including inventory property) which are disposed of within 10 years after a C corporation becomes an S corporation.¹² The tax is imposed at the maximum corporate rate for the year in which the disposition occurs applied to the lesser of—(1) the net recognized built-in gains (the net of built-in gains and built-in losses) or (2) the amount of taxable income if the corporation were not an S corporation.¹³ Even though no gain or loss may be recognized at the S corporation level (except, possibly for built-in gains), income tax is imposed at the shareholder level as with C corporations.¹⁴

**Removing assets from the C corporation**

One strategy is to increase dividend distributions and reduce compensation levels. Before the 2003 Act, compensation paid by a C corporation generally offered greater net returns to individual employee-shareholders than dividends (compensation was deductible at the corporate level, dividends were not). Moreover, compensation was (and is) subject to FICA tax.

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That result has changed under JGTRRA. Assuming a 25 percent marginal corporate rate and a 35 percent marginal individual rate, with a comparison of $10,000 paid as a dividend or $10,000 paid as compensation, the results favor a dividend declaration—

<table>
<thead>
<tr>
<th>Compensation</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>10,000.00</td>
</tr>
<tr>
<td>FICA tax</td>
<td>710.60</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>0</td>
</tr>
<tr>
<td>Available to distribute</td>
<td>9,289.40</td>
</tr>
<tr>
<td>Individual FICA tax</td>
<td>710.60</td>
</tr>
<tr>
<td>Individual income tax</td>
<td>3,251.13</td>
</tr>
<tr>
<td>Net to recipient</td>
<td>5,327.50</td>
</tr>
</tbody>
</table>

With some employee-shareholders now preferring a dividend distribution, the issue of reasonableness of compensation from a corporate employer may turn on whether salary is too low, rather than too high. Numerous cases have been litigated on that issue in an S corporation context. If IRS asserts that compensation was unreasonably low, a shareholder employee may seek to characterize the excess as a dividend. The regulations still characterize the excess as a dividend if payments bear a close relationship to shareholders and are found to be a distribution of earnings and profits. In a 1981 case, where there was no proof of earnings and profits, the Tax Court held that excess payments were not dividends and were not for services rendered.

Another option is effectively to liquidate by making a distribution to shareholders which would be characterized as a dividend to the extent of the corporation’s earnings and profits which would be taxed at a maximum of 15 percent. If the distribution exceeds earnings and profits, income tax basis is reduced (which does not produce taxable income) with the excess over basis generally treated as a sale or exchange of property taxable as capital gain (taxed at a maximum rate of 15 percent). After the distribution, the shareholder could end up with stock with little or no value but a significant amount of income tax basis with a capital loss to that extent on ultimate liquidation, subject to capital loss limitations. The distribution may also be subject to alternative minimum tax.

Of course, the corporation must recognize gain (effectively as ordinary income inasmuch as the five and 15 percent rates on long-term capital gains do not apply to corporations) on the liquidation of appreciated assets into cash or on distribution of appreciated assets in complete liquidation. Thus, a corporation heavily invested in real and personal property (other than cash) is likely to face a heavy corporate-level tax on declaration of a dividend.

FOOTNOTES

2. I.R.C. § 1(h)(1), 55(b)(3), amended by JGTRRA, Sec. 301.
11. See Ltr. Rul. 9218019, January 23, 1992 (no recognition of gain or loss on distribution of cash in complete liquidation of S corporation; any gain or loss would be recognized by S corporation’s shareholders but no built-in gains tax on sale of real estate because held on December 31, 1986).
17. Id.
19. The court held the excess amount was not subject to the maximum tax on personal service income under then-I.R.C. § 1348 (repealed by Pub. L. No. 97-34, Sec. 101(c)(1), effective for taxable years after 1981).
20. I.R.C. §§ 301(c)(1), 316.
22. I.R.C. § 1(h)(1).