

## ARTICLE

# Tax Issues Concerning Independent Contractors and Loan-Out Corporations (Part 2)<sup>1</sup>

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## Part 2 — Loan-Out Corporations

### I. General

Historically, a number of benefits were available to loan-out corporations that were not available to individuals, including greater deductible pension plan contributions, ability to defer income through use of a fiscal year, deduction of more fringe benefits such as medical insurance, and lower corporate tax rates. Legislation over recent years has dramatically narrowed these benefits. Nevertheless, in certain circumstances, a loan-out corporation may still offer significant benefits.

A loan-out corporation is typically a corporation wholly owned by the worker ("shareholder-employee") where the shareholder-employee has an exclusive, long-term agreement to provide services to the corporation as the corporation designates. Generally, the ultimate recipient of the shareholder-employee's services contracts with the loan-out corporation and pays all compensation to the loan-out corporation. In turn, the loan-out corporation pays compensation to its shareholder-employee, under the employment agreement, generally zeroing out its income through

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payments of compensation to its shareholder-employee, contributions to qualified pension plans, and payment of other benefits for the employee and other business related expenses. A variation of this structure in the entertainment industry is the so-called rent-a-star company that has service agreements with a number of artists who may or may not be shareholders.

## II. Non-Tax Considerations in Forming Loan-Out Corporation

### A. Limited Liability

If maintained properly, e.g., the proper corporate formalities are observed and the loan-out corporation is properly capitalized, the loan-out corporation may enable the shareholder-employee to limit his or her liability to outside creditors. State law generally provides that professionals such as attorneys and physicians may not use the corporate shield to limit their liability in malpractice actions relating to their own work. In addition, several courts have held that the sole shareholder, officer, and director of a corporation are liable for copyright infringement by the corporation since the shareholder exercised dominant influence on the corporation and determined the policies that resulted in the infringement.<sup>3</sup>

### B. Workers' Compensation

A loan-out corporation that performs services for a third party is not covered by that party's workers' compensation insurance unless the policy specifically includes loan-out corporations. If the employee of the loan-out corporation suffered personal injury on the job, he or she would be entitled to seek damages under general tort laws. Most film producers include independent contractors and loan-out corporations under their workers' compensation policy, even though it is not entirely clear that these clauses are enforceable or circumvent the independent contractor's right to seek damages under general tax law.

### C. Administrative Costs

Since the loan-out corporation is a separate entity, it must maintain its own books and records, file its own income tax returns, and undertake other administrative matters. Accordingly, the cost of administering the loan-out corporation must be compared to the savings to be obtained by its formation to ascertain whether its formation is worthwhile. Where limited liability is a primary factor for forming the loan-out corporation, its maintenance cost may be a less important factor.

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<sup>3</sup> See also *Warner Bros., Inc. v. O'Keefe*, CCH Copyright Law Dec. ¶25,091 (S.D. Ia. 1977).

#### D. Qualification to Do Business in Other States

A loan-out corporation may be required to qualify to do business in any state in which it operates in addition to the state of its incorporation. Such qualification may require payment of significant filing fees and taxes.

### III. Tax Considerations in Forming Loan-Out Corporation

#### A. Qualified Retirement Plans

1. *Employees Limited to IRA.* An individual who is an employee of a business is prohibited from creating his or her own pension plan even if not covered by a qualified pension plan maintained by such business. That individual is limited to maintaining the much more modest IRA form of plan. Section 219 limits IRA contributions to \$2000 (or \$2250 for a spousal IRA) and phases out this deduction where the taxpayer (or taxpayer's spouse) is an active participant in a qualified plan and his or her adjusted gross income exceeds \$10,000. By forming a loan-out corporation, this individual may be able to establish a corporate pension plan.<sup>4</sup> This is particularly important to workers who go from one job to another and do not work with one entity long enough to become covered by its qualified pension plan.

2. *Allowable Contributions to Corporate Pension Plan.* A corporate pension plan can be either a defined contribution plan (a plan where contributions are made to an account for the participant and the retirement benefits are based solely on the balance in the account) or a defined benefit plan (a plan wherein the benefits to be received on retirement are defined and contributions are made to the plan in such amounts as needed to meet this future benefit payment). Under §415, the maximum contribution allowable under a defined contribution plan is the lesser of (i) 15% (profit-sharing plan) or 25% (money purchase plan) of the employee's compensation for the year, or (ii) \$30,000. The maximum benefit payable under a defined benefit plan is the lesser of (i) \$90,000 adjusted by cost-of-living increases (\$115,641.00 for 1993), or (ii) the employee's average compensation for his or her three consecutive highest compensation years (not exceeding \$235,840.00 for 1993).

#### B. Fringe Benefits

A loan-out corporation typically can deduct the cost of many employee benefits that a self-employed person would not be entitled to deduct.

<sup>4</sup> But see discussion below regarding *Sargent v. Comr.*, 959 F.2d 1252 (8th Cir. 1991), *rev'g* 93 T.C. 572 (1979).

1. *Medical Insurance.* A loan-out corporation can deduct the cost of medical insurance premiums and the employee is not taxable on these payments. §§162 and 105. In addition, a loan-out corporation may deduct medical costs it pays on behalf of an employee and that are not covered by insurance, and the employee will not be taxable on the amounts paid on his or her behalf so long as prescribed nondiscrimination rules set out in §105(h) are satisfied. Where there is no other employee of the corporation, the nondiscrimination rules are not problematic. In contrast, a self-employed person may deduct only 25% of the cost of medical insurance premiums. Even this limited deduction expired on June 30, 1992, but pending tax legislation would renew the deduction on July 1, 1992 and extend it through 1993. §162(1). In addition, a self-employed individual may deduct other medical costs only to the extent such costs exceed 7½% of his or her adjusted gross income and may deduct only insulin and prescription drugs. §213.

2. *Disability Insurance.* A loan-out corporation may pay disability insurance premiums and deduct this cost while the employee is not taxable on the cost of the premiums. However, if the loan-out corporation pays the premium for disability insurance, subsequent benefits received by the employee will be taxable. If the employee pays the premium, benefits later received will not be taxable. §104(a)(3). Some advisors recommend that the employee pay all premiums at the beginning of the year and the corporation reimburse the employee at the end of the year if no disability has occurred. It is questionable whether the exclusion would be allowed if this reimbursement program was ongoing.

3. *Group Term Life Insurance.* Under §79, a loan-out corporation may provide up to \$50,000 life insurance, and the cost of the premiums is not taxable compensation to the shareholder-employee. If the loan-out corporation has more than one employee, nondiscrimination rules apply.

4. *Death Benefit.* A death benefit of up to \$5000 can be paid to the estate of an employee, but is not available in the case of a self-employed individual. §101(b).

#### C. Fiscal Year

Generally, a loan-out corporation can elect any fiscal year it chooses, which offers the opportunity to defer income for tax purposes. The deferral is as follows: The corporation elects a fiscal year of January 31. During the period from February 1 through December 31 of 1992, the corporation pays a minimal salary to its shareholder-employee but, in January of 1993, pays a substantial bonus. The corporation would be permitted to deduct all of the compensation payment for its fiscal year ending January 31, 1993, but the shareholder employee would not report the bonus income until April 15, 1994 for his or her

calendar year, thereby obtaining a one-year deferral for reporting this income.<sup>5</sup>

However, §441(i)(1) provides that a "personal service corporation" must use the calendar year unless it can establish a business purpose for using a different fiscal year. Deferral of income to its shareholders does not count as a business purpose.

A corporation may be a "personal service corporation" if *any* of its stock is owned by a shareholder-employee. §441(i)(2). The attribution rules of §318 apply, modified to provide for attribution from corporations to shareholders who own *any* stock in the corporation.

Regs. §1.441-4T(c) refers to Regs. §1.448-1T(d)(4)(i) for the definition of "personal services". Under these regulations, "personal services" include only services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

A personal service corporation otherwise required to use a calendar year under §441(i) may, under §444, elect a fiscal year of September, October, or November. For this purpose, the "personal service corporation" is given the same meaning as in §269A, which may vary from the definition in §441(i) discussed above.

A corporation that elects such a fiscal year becomes subject to the minimum distribution requirements of §280H, which defer the corporation's deduction for part of the compensation paid to the shareholder-employee until the corporation's next fiscal year. The minimum distribution amount is the lesser of the following:

- All payments treated as gross income to the shareholder-employee in the prior fiscal year (other than taxable dividends and gain from the sale or exchange of property), divided by 12, and multiplied by the number of months in the corporation's fiscal year before December 31; or
- The product of the corporation's adjusted taxable income (without deduction for compensation paid to a shareholder-employee) times an historical payout percentage. The historical pay-out percentage is equal to the total payments to shareholder-employees in the preceding three taxable years, divided by the total "adjusted taxable income" (as defined in §280H(f)(4)) for those three years, but not to exceed 95%.

If the minimum distribution requirements are not met, the corporation may deduct for that fiscal year only those amounts paid to the shareholder-employee before December 31, annualized to a 12-month period.

<sup>5</sup> The corporation would, however, be obligated to withhold federal income tax on the bonus at the rate of 20%. State income tax withholding could also apply.

#### D. Accounting Method

Under §448, a loan-out corporation must use the accrual method of accounting unless it meets one of two exceptions:

- It is a "personal service corporation"; or
- Its average annual gross receipts for the 3-year period preceding the taxable year (or if the corporation has been in existence for less than three years, for the period it has been in existence) does not exceed \$5 million.

A "personal service corporation" for this purpose is one engaged in the same type of services described above for application of §441 is *substantially owned* by employees, retired employees, the estate of any such employee, or a person who inherited the stock by any such employee. For purposes of determining stock ownership, community property rules are disregarded, stock held by a qualified retirement plan is treated as held by an employee, and certain affiliated groups of corporations can be treated as one taxpayer. §448(d)(4).

A person using the accrual method for amounts to be received for the performance of services is not required to accrue any portion of such amounts that on the basis of experience will not be collected, *unless* interest is required to be paid on such amount or there is a penalty for failure to make timely payment. §448(d)(5).

Under §267, a loan-out corporation may not deduct payments of compensation paid to a shareholder-employee who owns more than 50% of the corporation until such date as the shareholder-employee is required to report the payment as income. Thus, a loan-out corporation using the accrual method of accounting may not accrue and deduct compensation payments to its shareholder employee in a taxable year before the date the cash basis shareholder-employee is required to report it as income. In the case of personal service corporations and shareholder-employees, as defined in §§269A and 441(i), a lower threshold ownership requirement applies.

#### E. Tax Withholding

A loan-out corporation must pay FICA and FUTA taxes on salaries paid to its shareholder-employees and withhold income taxes and the employee share of FICA taxes on compensation payments to the shareholder-employee. Since SECA tax (imposed on self-employed persons) is now the same as the combined employer and employee FICA tax, and one-half of SECA tax is deductible by the self-employed (to match deductibility of the employer's share of FICA), there is no additional cost nor savings from incorporation regarding FICA. However, incorporation will result in the imposition of the FUTA tax that is not imposed on self-employed persons. Typically, this cost

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is more than offset from tax savings realized by the corporation from deductibility of employee fringe benefits.

### F. Limitations on Deductions of Employee Business Expenses/Impact on Alternative Minimum Tax

Where a worker would be an "employee," forming a loan-out corporation can help avoid the limitation on deductibility of employee business expenses under §67 to the extent they do not exceed 2% of the employee's adjusted gross income and the potential onerous application of the alternative minimum tax under §56(b)(1)(A).

### G. Asset Removal — Impact of Repeal of General Utilities

Historically, appreciating assets could be removed from a corporation by distributing the assets in liquidation of the corporation on a tax-free basis under §333 or selling the assets to a third party and liquidating the corporation under §337. The Tax Reform Act of 1986, however, repealed these provisions. Consequently, on the sale of assets by a corporation or the distribution of its assets in liquidation, the corporation recognizes taxable gain equal to the excess of the amount received for the assets (in the case of a sale) or the fair market value of the assets (in the case of a liquidation) over the corporation's adjusted basis in the assets. In the case of copyrights created by the loan-out corporation's shareholder-employee, the basis is typically low and the potential appreciation substantial. Accordingly, it is advisable to keep intangible assets outside of the corporation and license the right to use such intangibles to the corporation.

### H. Reasonable Compensation

Regs. §1.162-7(a) provides for deductibility of a "reasonable allowance for salaries or other compensation for personal services actually rendered." Where compensation is paid to shareholders who also render services to the corporation, the IRS may seek to disallow deduction of part of the compensation on the ground that it is "unreasonable" in relation to the services rendered and that part of the compensation is in fact a disguised dividend to the shareholder-employee.

For purposes of determining the "reasonableness" of a shareholder-employees compensation, all direct and indirect benefits, including salary payments, bonuses, employee benefits, and qualified pension plan contributions are generally included. See *Bianchi v. Comr.*, 66 T.C. 324 (1976), *aff'd without pub. opin.*, 553 F.2d 93 (2d Cir. 1977) (contribution to a qualified pension plan and compensation paid to a dentist in the first year of his loan-out corporation's first year was unreasonably high and nondeductible). Death

benefits payable to a deceased employee's estate are also included. See *Oppenheimer Casing Co. v. Comr.*, 22 T.C.M. 1082 (1963).

In the case of a loan-out corporation, factors typically considered in determining reasonableness include:

- The relationship of compensation paid from the loan-out corporation to compensation earned by the shareholder-employee before incorporation;
- the experience and particular expertise of the shareholder-employee;
- the amount of time and energy devoted by the shareholder-employee to the work of the corporation;
- the extent to which the corporation's earnings are attributable to the work done by the shareholder-employee;
- whether the shareholder-employee was inadequately compensated during the early years of the loan-out corporation's existence due to the formation of the business and insufficient cash flow;
- the comparability to compensation paid to similar persons performing similar services;
- the dividend history of the loan-out corporation; and
- the contractual agreements between the loan-out corporation and its shareholder-employee.

In *Klamath Medical Serv. Bureau v. Comr.*, 261 F.2d 842 (9th Cir. 1958), *aff'g* 29 T.C. 399 (1957), *cert. denied*, 359 U.S. 966 (1959), *acq.*, 1960-2 C.B. 5, the court held that compensation paid to physicians of up to 100% of their base fee billings was reasonable but excess payments (derived from service contracts and from operating hospitals) were not.

The Tax Court in *McClung Hosp. v. Comr.*, 19 T.C.M. 449 (1960), held that compensation paid to physicians in an amount equal to their entire billings without reduction for expenses or uncollectible accounts was reasonable. Rev. Rul. 79-8, 1979-1 C.B. 92, involved the question of whether compensation paid to a shareholder/employee of a closely held corporation was unreasonable when the corporation has not paid dividends on its stock. The Service ruled that the failure to pay dividends was a significant factor, although not conclusive.

*Richlands Medical Ass'n v. Comr.*, 60 T.C.M. 1572 (1990), involved three physicians (who operated a medical practice) and a local hospital. The Tax Court held that the physicians were entitled to compensation equal to 100% of the collections attributable to their personal services and were entitled to additional compensation for their management duties. The court rejected the taxpayers' argument that *Klamath* and *McClung* established as a matter of law that physicians are entitled to compensation equal to

100% of billings. The Tax Court also took into account the failure of the corporation to pay dividends and a provision in the bylaws that provided that all of the corporation's net profits would be distributed as bonuses in disallowing deduction of part of the compensation.<sup>6</sup>

To avoid disallowance of deduction of compensation as "unreasonable," the following actions are advisable:

- Execute an employment agreement between the loan-out corporation and the shareholder-employee;
- properly document raises, bonuses, and other increases in employee compensation in corporate minutes;
- retain a small amount of income in the corporation;
- avoid generating a net operating loss at the corporate level;
- pay bonuses pursuant to a specific provision set forth in the employment agreement, base the bonus on some quantifiable figure other than as a stated percentage of the corporation's net profit, and pay the bonus periodically during the year rather than only at the end of the year;
- set salary in the employment agreement as a stated dollar amount or based upon production. If salary is based upon a percentage of the corporation's profits, it is better to establish it as a percentage of revenues and not net profits and anticipated expenses should be estimated;
- pay some dividends; and
- provide in the employment agreement that the shareholder-employee will repay compensation determined to be unreasonable.<sup>7</sup>

Arguably, where the loan-out corporation's income is derived solely from the efforts of a shareholder-employee, and not from capital assets or efforts of other employees, payment of all of the corporation's profits to the shareholder-employee is reasonable.

<sup>6</sup> See also *Medical Collection Corp. v. Comr.*, 36 T.C.M. 1074 (1977); *Eduardo Catalano, Inc. v. Comr.*, 38 T.C.M. 763 (1979); *Home Interiors and Gifts, Inc. v. Comr.*, 73 T.C. 1142 (1980); *La Mastro v. Comr.*, 72 T.C. 377 (1979); *Bianchi v. Comr.*, 66 T.C. 324 (1976), *aff'd in an unpub. opin.*, 553 F.2d 93 (2nd Cir. 1977); *Elliott's, Inc. v. Comr.*, 83-2 USTC ¶9610 (9th Cir. 1983); *Owensby & Kritikos, Inc. v. Comr.*, 50 T.C.M. 29 (1985).

<sup>7</sup> In *Oswald v. Comr.*, 49 T.C. 645 (1968), *acq.*, 1968-2 C.B. 2, the Tax Court held such repayments were deductible by the shareholder-employee. The Service has outlined the requirements in Rev. Rul. 69-115, 1969-1 C.B. 50, for deduction of repaid compensation. Some commentators have raised concern that repayment clauses may evidence the shareholder-employees' knowledge that compensation was unreasonable in the first place. In addition, an *Oswald* agreement may not be enforceable under state law in the case of a solely owned corporation where the employee executing the agreement is the sole shareholder of the corporation.

## I. Reduced Challenge of Deductible Expenses

Many advisors believe that deductions are less likely to be challenged by the IRS if claimed on a corporate income tax return rather than Schedule C of an individual income tax return.

## J. Impact of Foreign Taxes

1. *Recognition.* Some countries do not recognize loan-out corporations and will tax the shareholder-employee directly.

2. *Artists and Athletes Clauses.* Most modern tax treaties include "artists and athletes" clauses, which provide that income earned by an artist or athlete may be taxable in the country in which the income is sourced even if paid to a loan-out corporation. Absent this clause, income paid to a loan-out corporation would typically be exempt from tax in the source country due to the standard provision in tax treaties that "business profits" will be taxable only in the country of residence unless the taxpayer maintains a permanent establishment in the source country.

3. *Utilization of Foreign Tax Credit.* Use of a loan-out corporation in a foreign jurisdiction may adversely impact utilization of the foreign tax credit. For example, Canada does not allow deduction of retirement plan contributions. Accordingly, a loan-out corporation that earns income in Canada and contributes part of those earnings to a retirement plan will not, for Canadian tax purposes, zero out its income since the contribution to the plan will not be deductible. The loan-out corporation will thus owe Canadian tax. However, if it zeroes out its income for U.S. tax purposes through compensation payments to its shareholder-employee, retirement plan contributions, and payments of other expenses, as is typically the case, it will have no U.S. tax liability against which to offset the available foreign tax credit attributable to the Canadian tax paid. The foreign tax credit does not flow through to the shareholder-employee unless the loan-out corporation elects Subchapter S status.

## K. Dividends Received Deduction

A corporation is generally entitled to deduct dividends received from another domestic corporation equal to 70% of dividends received from non-affiliated corporations. A higher percentage deduction is allowable for dividends received from affiliated corporations and a deduction is allowed for a portion of dividends received from foreign corporations where certain stock ownership requirements are met. §243.

## L. Personal Holding Company Income

Section 541 imposes a 28% tax on personal holding companies on all of the "undistributed personal holding company income." A corporation is a "personal

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holding company" if more than 60% of its adjusted ordinary gross income is "personal holding company income" and at any time during the past taxable year more than 50% of the value of its outstanding stock is owned by five or fewer individuals. §542.

Under §543, "personal holding company income" is defined to include income from personal service contracts. This term is more specifically defined in §543(a)(7) as:

[a]mounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

[a]mounts received from the sale or other disposition of such a contract.

This applies as to amounts received for services under a particular contract only if at some time during the past taxable year 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description), as the one to perform, such services.

In *Claggett v. Comr.*, 44 T.C. 503 (1965), *acq.*, 1966-2 C.B. 4, the Tax Court held that a mere expectation that a certain individual will perform the requested services is not sufficient to create personal holding company income. In Rev. Rul. 75-67, 1975-1 C.B. 169, dealing with a loan-out corporation that provided medical services, the Service ruled that, even though an individual patient will typically seek out the services of a particular physician and will generally be treated by the physician sought, the creation of a physician-patient relationship in this context does not constitute a "designation" for this purpose. The Service ruled that "designation" means either a specific contractual agreement or evidence that the services are so unique as to preclude substitution of another. In Rev. Rul. 75-249, 1975-1 CB 171, the Service ruled that income paid to a musician by his wholly owned corporation was not personal holding company income in the absence of contracts between the corporation and its clients designating that the musician would personally perform the services.

On the other hand, in *Kenyatta Corp. v. Comr.*, 86 T.C. 171 (1986), the Tax Court imposed the personal holding company tax where a loan-out corporation, owned by basketball player Bill Russell, entered into various agreements to provide Bill Russell's services. In several contracts, he was specifically designated as the person to provide services. In a contract to make commercials, he was not specifically designated, but

the court found that Russell's talents were unique and substitution would not have been possible.<sup>8</sup>

To avoid the personal holding company tax:

- All contracts, where possible, should be drafted without designation of any particular person to perform services;

- where an individual has already entered into a contract with a third party and then incorporates, a new contract should be entered into between the third party and the new corporation rather than simply assigning the existing contract;

- the income of the corporation should be zeroed out; and

- query whether a provision that the employee shall remain as president of the loan-out corporation, or some similar position, will work to insure that only a certain person will render services without running afoul of the personal holding company provisions.

### M. Accumulated Earnings Tax

Sections 531-537 impose an additional penalty tax of 28% on "accumulated taxable income." The purpose is to prohibit the indefinite accumulation of earnings, thus requiring corporations to pay dividends to its shareholders. This is not a frequent problem encountered by loan-out corporations, as a loan-out corporation typically pays most of its income to its shareholder-employee through deductible payments of compensation, qualified pension plan contributions, and payment of other business expenses. Moreover, so long as the corporate income tax rates exceed individual income tax rates, there is little incentive in a typical loan-out corporation to accumulate income.

The accumulated earnings tax is not imposed to the extent that the accumulated earnings do not exceed \$150,000 in the case of corporations engaged in the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or \$250,000 in the case of other corporations. In addition, the tax does not apply where the corporation can show that the accumulation of income is for "the reasonable needs of the business," and it does not apply to personal holding companies.

### N. Marginal Tax Rate

Section 11(b)(2) provides that the highest marginal corporate income tax rate of 35% shall apply on all

<sup>8</sup> See also *Kurt Frings Agency, Inc. v. Comr.*, 42 T.C. 472 (1964), where the Tax Court imposed the personal holding company tax where Kurt Frings, who managed various artists, was specifically designated as the service provider in contracts between his loan-out corporation and the artists.

income of "qualified personal service corporations." Accordingly, these corporations do not get the benefit of the graduated income tax rates. For this purpose, the definition of "qualified personal service corporation" set forth in §448(d)(2) (discussed above) applies.

### O. Collapsible Corporations

The collapsible corporation provisions in §341 are designed to prevent taxpayers from converting what would ordinarily be ordinary income to capital gain. While these provisions are less important than in the past, since there is not a substantial difference between current tax rates imposed on ordinary income and capital gain, these provisions may regain significance if the differential between ordinary income and capital gain tax rates is increased through legislation.

A classic situation in which the collapsible corporation provisions apply is where a film producer establishes a corporation for the production of a film and, before its release and receipt of any royalty income, the corporation is dissolved and the shareholder realizes capital gain on the distribution of the film to him or her equal to the difference between the value of the film and the adjusted basis in his or her stock. The shareholder then sells the film, recognizing no income subject to the higher ordinary income tax rate on the sale since the shareholder's basis in the film was stepped up to its value on the liquidation.

A "collapsible corporation" is defined in §341(b) as a corporation formed or availed of principally for the manufacture, construction, or production of property or for the purchase of property which qualifies as a "Section 341 asset" with a view to:

the sale or exchange of stock by its shareholders, ... or a distribution to its shareholders, before the realization by the corporation ... of  $\frac{2}{3}$  of the taxable income to be derived from the property; and

the realization by such shareholders of a gain attributable to such property.

Section 341(b)(3) defines "Section 341 assets" as any property held for less than three years which constitutes inventory, other property held by the corporation primarily for sale to customers in the ordinary course of its business, all property described in §1231(b) (depreciable equipment and real estate used in a trade or business but excluding property use to manufacture inventory or other property held for sale to customers), and unrealized receivables or fees from the sale of the foregoing types of property.

A number of limitations apply to the application of the collapsible corporation provisions. For example, the provisions only apply to shareholders who own more than 5% of the value of the outstanding stock of the corporation. In addition, 70% of the gain recognized during the taxable year must be attributable to

§341 assets. The provisions do not apply to assets held more than three years following the completion of its manufacture, construction, production or purchase. Finally, an exemption is provided where the net unrealized appreciation in certain assets does not exceed 15% of the corporation's net worth. The provisions can be avoided also by making a "Section 341(f) election" under which the corporation, the stock of which is being sold, agrees that it will recognize a gain on any later disposition of certain assets notwithstanding the availability of a nonrecognition provision.

## IV. Subchapter S v. Subchapter C Corporations

### A. Requirements for Electing Subchapter S Status

Under §1371 *et seq.*, a number of technical requirements must be met before a corporation is eligible to elect Subchapter S status:

- The corporation can have no more than 35 shareholders and the shareholders must be individuals who are U.S. citizens or resident aliens or certain permitted trusts;
- the corporation can have only one class of stock;
- the corporation must use the calendar year, except that it can elect a fiscal year of September, October, or November under §444 if it agrees to make enhanced estimated tax payments under §7519; and
- the corporation must not have passive investment income that exceeds 25% of its gross receipts for three consecutive years if the corporation has Subchapter C earnings and profits.

### B. Advantage of Subchapter S Status

A number of advantages accrue to corporations that elect Subchapter S status. Generally, an S corporation is not taxed as an entity and the income generated by an S corporation is taxed to its shareholders, whether paid out to them or retained by the corporation. Losses generated in an S corporation are deductible by the shareholders on their individual income tax returns to the extent of their basis in the stock and unused losses are carried over until the shareholders have sufficient basis to utilize the losses.

The reasonable compensation issue is somewhat ameliorated by election of S status since all of the corporation's income is taxed to the shareholders. Nevertheless, some issues remain. The IRS may still assert that compensation is unreasonable and a portion thereof properly taxable as a dividend where such re-characterization would limit the amount of allowable contributions to qualified pension plans. Where all of the corporation's income is paid out as dividends to