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## TAXATION OF THE TREASURES OF THE SEA

JOHN J. KENNY† AND RONALD R. HRUSOFF††

TO SPEAK of “treasures of the sea” evokes for most of us visions born in childhood, of pirates and buried chests and all the trapping of the Robert Louis Stevenson tales. And in fact the gold coins and precious stones sought by Elizabethan adventures still exist; current periodicals record their recovery with surprising frequency. However, today’s explorer more often seeks the commonplace minerals — oil and sulphur — and is most concerned with the tax aspects of his venture. This article will attempt to pinpoint, and perhaps answer, a few of the tax problems connected with treasure hunting.

A treasure hunting venture can be organized in the same manner as any other business activity. However, exploration ventures lend themselves to more flexible structures than many other businesses, and for this reason certain tax savings are available. That is, the organizers have a choice between three different modes of operation, each with its own peculiar advantages and each best adapted to a different factual situation: (1) operation as private entrepreneurs; (2) operation as a corporation; and (3) operation as a Subchapter S corporation. The option to operate in the noncorporate form should be carefully exercised, for such a determination bars the explorers from making effective use of a corporation should they have a change of heart. We shall first discuss the noncorporate amateur operation, and then turn our attention to the corporate form — especially the Western Hemisphere Trade Corporation. Finally, the Subchapter S corporation — something of a compromise between the other two — will be considered.

## I. NONCORPORATE OPERATION

The entrepreneur who discovers or develops one of the treasures of the sea naturally hopes to maximize his profits. Such maximization will be greatly enhanced if any profits will receive capital gains treatment, and capital gains treatment requires a bit of tax planning in the formative stages of the venture. The capital gains provisions are among

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the oldest in the Tax Code,<sup>1</sup> dating from the Revenue Act of 1864.<sup>2</sup> Sadly, they also rank among the most confused and least satisfactory of all sections.<sup>3</sup> This is due in no small part to the fact that the statute represents a compromise between contradictory tax theories,<sup>4</sup> coupled with an attempt to stimulate the investment sector of the economy.<sup>5</sup> It is unfortunate that greater attention was not given at the outset to the economic theories upon which the capital gains provisions rest. It is even more unfortunate that Congress in the formative

1. The capital gains provision first became a permanent part of the Code in 1921. Revenue Act of 1921, ch. 136, § 206, 42 Stat. 232.

2. Ch. 173, § 116, 13 Stat. 281 (1864). This enactment, by present standards, was extremely crude providing only "that net profits realized by sales of real estate purchased within the year for which income is estimated, shall be chargeable as income. . . ." In 1867 the tax was extended to property purchased within two years. Act of March 18, 1867, ch. 169, § 116, 14 Stat. 478. The 1867 Act was held constitutional in *Gray v. Darlington*, 82 U.S. (15 Wall.) 63 (1872).

3. The Senate Minority Report, S. REP. No. 275, 67th Cong., 1st Sess. pt. 2, at 6 (1921), in a sense anticipated this problem when it pronounced that the bill "is wholly unsatisfactory from any standpoint. The country is bound to be dissatisfied. . . ." See also Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 987 (1956):

[W]hen Congress in the Revenue Act of 1921 introduced the term "capital gain" into our technical tax law and was therefore faced with the problem of defining that term, it was embarking upon a journey through areas previously unexplored in this country. When we turn from the beginning of that journey in 1921 and pass over thirty-five years to arrive at the present definition in the Revenue Code of 1954 we see that while Congress has added many maps and charts and much elaborate equipment, it has not uncovered a clear and useful trail.

4. One theory urges Congress to tax capital gain at regular income rates. It is argued that the individual receiving the gain is receiving the same amount of purchasing power that he would receive from an equal amount of ordinary income. Therefore, he should pay the same tax. This line of reasoning discounts any need to stimulate investment by favorable tax treatment. The opposing theory demands that no tax be placed on capital gain and that the government look solely to income, not appreciation, for its revenue. In support of this position it must be remembered that mere increase in the value of a security, however many times it may be transferred, produces no economic gain. And these profits will be taxed, indirectly through the increased income they will generate when reinvested, or directly through the estate tax. KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* 212 (Harcourt, Brace ed. 1935); cf. *Commissioner v. Brown*, 380 U.S. 563, 581 (1965) (Harlan, J., concurring). The present tax structure attempts to straddle both theories. Gain is taxed at less than full rates — evidently with some thought of encouraging investment — and the income from the investment is taxed at full rates. Standing by itself the theory is not without merit; however, once the purity of either system was abandoned, Congress has found it easy to enact a series of special exceptions whereby ordinary income will receive capital gains rates. A retreat to either of the two primary theories would substantially simplify the entire structure.

5. H.R. REP. No. 350, 67th Cong., 1st Sess. 1, 10-11 (1921), indicates that Congress gave some thought to the possibility that investment in capital assets would be stimulated by taxing capital gains at less than full rates. As this was fourteen years before Keynes came out with *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* and as Congress consistently increased rates during the depression — off-setting its pump-priming efforts — a serious question is raised whether Congress actually was aware of the full impact a tax-cut (especially one on capital gain) would have on the investment sector of the economy. See generally PAUL, *TAXATION IN THE UNITED STATES* 167 (1954). Serious consideration of the tax-structure vis-à-vis economy had to wait until after the Second World War. See Joint Committee on the Economic Report, *Economics of Capital Gains in Taxation*, in *FEDERAL TAX POLICY FOR GROWTH AND STABILITY*, 84th Cong., 1st Sess. 367-419 (1955); cf. INT. REV. CODE OF 1954, §§ 38(a), 46(a)(1) (7% tax credit for profits reinvested in the business) [references to the 1954 Code will hereinafter be by section only].

years shifted from one concept to another<sup>6</sup> and now steadfastly refuses to reassess these theories, preferring instead to add a special interest provision here, tighten a restriction there, or alter the rates or the holding period at almost every session.<sup>7</sup> "Capital gain", as it is commonly called,<sup>8</sup> results from the sale by a taxpayer of a capital asset<sup>9</sup> other than property held "primarily for sale to customers in the ordinary course of his trade or business."<sup>10</sup> The simplicity of the definition is deceptive; for even today, years after enactment, great uncertainty

6. In 1921 the House bill provided that all gain in excess of \$29,000 would be taxed at a flat rate of 12½%. Amendments in the Senate required the taxpayer to only include 40% of the gain in his income where it would be taxed at regular rates. S. Doc. No. 73, 67th Cong., 1st Sess. 21-22 (1921). As enacted the statute was a compromise. Capital gain (from property held over two years) was separated from ordinary income and taxed at a flat rate of 12½%. Revenue Act of 1921, ch. 136, § 206, 42 Stat. 232.

The 1934 Act contained two new concepts. Embodied in the House Bill was Secretary of the Treasury Morgenthau's proposal that capital losses be set-off only against capital gain. He complained that taxpayers were maximizing their positions by realizing their losses in the first two years when they could be deducted from ordinary income while delaying their gains in order that they would be taxed at the capital gains rate. H.R. REP. No. 704, 73rd Cong., 2d Sess. 9-10 (1934). The House Ways and Means Committee determined that the percentage of gain or loss to be taken into account should vary with the length of time the asset was held. The amount decreased in four steps from 100%, if held less than one year, to 40%, if held for more than five. H.R. REP. No. 704, *supra* at 10. With two minor exceptions the Senate agreed. It added a fifth bracket — 30% at ten years — and allowed the first \$2,000 of loss to be taken against ordinary income. S. REP. No. 558, 73rd Cong., 2d Sess. 12 (1934).

The House in 1938 attempted to refine the steps. It proposed that the amount of gain required to be included in the taxpayer's net income fall 2% each month the asset was held over a year until the seventy-sixth percentile was reached; at that point the reduction dropped to 1% a month for the next three years. H.R. REP. No. 1860, 75th Cong., 3d Sess. 8, 33-34 (1938). The Senate found this stepdown provision too complicated and rejected the entire concept. It substituted a provision similar to the one in existence today. The Senate version taxed all assets held over eighteen months at one-half of the taxpayer's normal rate, not to exceed 15%. S. REP. No. 1567, 75th Cong., 3d Sess. 5-7, 19-22 (1938). In conference the inevitable compromise was reached. The final bill adopted the Senate holding period of eighteen months; but a modified step scale was imposed: If the property was held for over eighteen but less than twenty-four months, two-thirds of the gain would be included; if it was held over twenty-four months only 50% was required to be added to net income. In any event the capital gain would not be taxed at more than 30%. S. Doc. No. 177, 75th Cong., 3d Sess. 14 (1938).

The final change was made in 1942. 50% of the gain was required to be included in net income if the property was held for six months while the ceiling was reduced from 30 to 25%. The justification for reducing the holding period was that six months was adequate to divide the speculators from the investors. S. REP. No. 1631, 77th Cong., 2d Sess. 50 (1942).

7. It is periodically suggested by the ABA, the Treasury, or a Congressional leader that the capital gains provision be modified. The President's 1963 tax message was typical of many of these suggestions. He proposed that the percentage-inclusion factor be lowered from 50 to 30% while the holding period was extended from six months to one year. See H.R. 11629, 87th Cong., 2d Sess. (1962); H.R. 2721, 87th Cong., 1st Sess. (1961); H.R. 9060, 86th Cong., 1st Sess. (1959). None of these bills were enacted.

8. By this we mean long-term capital gain, § 1222(3), taxed at one-half of taxpayers regular rate not to exceed 25%. §§ 1201(b), 1202.

9. Section 1221. Surrey believes that all property is to be treated as a capital asset, unless specifically excluded. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 988 (1956).

10. Section 1221(1).

cloaks almost every word in section 1221. Ultimately, judicial gloss applied to the "trade or business" clause will determine the form the venture takes and the moment of sale.

Since the taxpayer who attempts to locate and recover a sunken galleon can take out his profits only at the discovery stage, he is more restricted than one who discovers and develops a mine. At one time there was serious discussion based on the Tax Court's *Glenshaw Glass* decision<sup>11</sup> that treasure trove would be exempt from federal income taxation.<sup>12</sup> Revenue Ruling 53-61<sup>13</sup> dashed this hope. It provides that, "The finder of treasure-trove is in receipt of taxable income, for Federal Income Tax purposes, to the extent of its value in United States currency, for the taxable year in which it is reduced to undisputed possession." The Supreme Court then reversed *Glenshaw Glass*<sup>14</sup> and settled the question. However, as we will show, the ruling does not necessarily mean that treasure trove (or other mineral discoveries) is to be taxed at ordinary income rates — if held longer than six months. More likely, it will be taxed at capital gains rates if the taxpayer can qualify under one of two tests: (1) he must establish that he is an amateur treasure hunter; or (2) he must establish that he is not in the treasure-hunting business. As will appear, these two tests are in reality the same.

In 1944 the Second Circuit, in *Goldsmith v. Commissioner*,<sup>15</sup> rejected the argument that a playwright could receive capital gain when he sold a play to Paramount Pictures on the ground that it was his business to write and sell scripts. Scarcely two years later the Tax Court, in *Edward C. Myers*,<sup>16</sup> concluded that one not engaged in developing patents primarily for sale to customers in the ordinary course of his trade or business — the so-called amateur inventor — was entitled to treat profits from the sale of a patent as capital gain. Within the year the Commissioner acquiesced in this decision.<sup>17</sup> Four years later the Service had sobering afterthoughts,<sup>18</sup> but by then Congress had

11. 18 T.C. 860 (1952); see also *Highland Farms Corp.*, 42 B.T.A. 1314 (1940).

12. Note, *Taxation of Found Property and Other Windfalls*, 20 U. CHI. L. REV. 748 (1953).

13. 1953-1 CUM. BULL. 17, now Treas. Reg. § 1, 61-14(a) (1957).

14. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

15. 143 F.2d 466, 467 (2d Cir.), cert. denied, 323 U.S. 774 (1944).

16. 6 T.C. 258, 266 (1946). *Myers* was followed by *Hofferbert v. Briggs*, 178 F.2d 743 (4th Cir. 1949); *Thompson v. Johnson*, 50-2 U.S. Tax Cas. ¶ 9428 (S.D.N.Y. 1950); *Carl G. Dreyman*, 11 T.C. 153, 162 (1948), nonacq., 1950-2 CUM. BULL. 5; *William Kelly*, 6 CCH Tax Ct. Mem. 646 (1947); cf. *Ernest L. Fisher*, 7 CCH Tax Ct. Mem. 286 (1948). For an excellent discussion of the effect of the *Myers* decision see, *United States v. Zacks*, 375 U.S. 59, 62, 68-69 (1963).

17. 1946-1 CUM. BULL. 3.

18. The Commissioner withdrew his acquiescence. 1950-1 CUM. BULL. 7.

already accepted the amateur versus professional distinction as a valid principle of taxation:

When a person is in the profession of writing books, or creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income. . . .

If an amateur receives royalties on his book or other artistic work, they are treated as ordinary income, but if he holds his book or other artistic work for 6 months . . . and then sells it outright he can avail himself of a loophole which treats such a sale as the sale of a capital asset, not held primarily for sale to customers in the ordinary course of the taxpayers trade or business. As a result the taxpayer receives long-term capital gain treatment on the product of his personal effort.<sup>19</sup>

By enacting what is now section 1221(3)<sup>20</sup> — specifically withdrawing this privilege from all authors — Congress itself established the principal that absent a statutory provision to the contrary, an amateur who holds property which he created for longer than six months is entitled to capital gains treatment. And in 1954 it reaffirmed this principle while extending capital gains treatment to professional as well as amateur inventors.<sup>21</sup> Although the Commissioner has in recent years bitterly fought the amateur exemptions, the courts have stood almost uniformly opposed to his position — with only the Supreme Court at all sympathetic.<sup>22</sup> The reasoning supporting the conclusion that, absent statutory interference, an amateur inventor or writer is entitled to capital gain is equally adaptable to a group of treasure hunters.

Once the equation “amateur standing equals capital gains” is established, emphasis shifts to drawing that thin line between the amateur and the professional. Common sense tells us that our explorers cannot set up an exploring company and then claim to be amateurs; but beyond this point, guidance must come from the copy-

19. S. REP. No. 2375, 81st Cong., 2d Sess. 43-44 (1950).

20. Enacted in 1950 as § 117(j) (1) of the 1939 Code.

21. Section 1235(a); S. REP. No. 1622, 83rd Cong., 2d Sess. 438-40 (1954). By denying authors capital gains treatment while specifically extending it to inventors Congress once again demonstrates, in a most telling manner, just how important culture is to the American public. See Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and under the 1954 Code*, 64 YALE L.J. 1, 10 (1954).

22. Cf. *United States v. Zacks*, 375 U.S. 59 (1963); see also *United States v. Midland-Ross Corp.*, 381 U.S. 54, 56-57 (1965); *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134-35 (1960); *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46, 52 (1955). One might ask why a part-time inventor should be accorded capital gains treatment on the fruits of his labor while another person who “moonlights” in a drug store has his labors taxed as ordinary income. The answer defies logic. It can only be put down as another of those inconsistencies surrounding the capital gains provisions. See ALI, *DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION* 438-39 (1960); Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and under the 1954 Code*, 64 YALE L.J. 1 n.1 (1954).

right and patent cases. The decision most frequently cited in this regard is *Stern v. United States*.<sup>23</sup> While in the armed forces, Stern wrote a novel, "Francis," *The Talking Mule*; the book was eventually made into a movie, the profits from which became the subject of suit. Stern claimed that they were capital gain; the Commissioner took the view that they were ordinary income. Judge J. Skelley Wright held that the case turned on whether Stern wrote the book as a hobby or as part of his business, concluding:

[A] court should not be quick to put a man in business under Section 117(a) simply because he has been successful in earning extra income through a hobby or some other endeavor which takes relatively small [sic] part of his time.

Here the taxpayer is a newspaper publisher and has been, with the exclusion of the war years, actively directing newspapers since 1938. Virtually his entire time has been given to that endeavor. As a hobby he has written a few short stories, some of which have been productive of small amounts of income. On two occasions he has written screen plays. He has created the character Francis and written two novels about it. This literary work has taken relatively little of his time. It was more or less a relaxation from his principal employment. Under the circumstances, it can hardly be said that the taxpayer created "Francis" to hold as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."<sup>24</sup>

Judge Wright suggests that three factors are controlling: (1) the principal business of the taxpayer; (2) the relative amount of time spent on his hobby; and (3) the money previously earned from the hobby.<sup>25</sup>

Of course, in most instances, the taxpayer's principal business is plainly evident; more often than not it is his sole business. Thus, in *Herwig v. United States*,<sup>26</sup> the Court of Claims had no trouble finding that Kathleen Winsor was a housewife and her husband a student when she wrote *Forever Amber*. And in *Miller v. United States*,<sup>27</sup> the same court found that a plaintiff during the years in question "had no occupation except to tend his vegetable garden, harvest his hay, feed

23. 164 F. Supp. 847 (E.D. La. 1958), *aff'd per curiam*, 262 F.2d 957 (5th Cir.), *cert. denied*, 359 U.S. 969 (1959).

24. *Id.* at 851.

25. *Id.* at 850-51.

26. 122 Ct. Cl. 493, 105 F. Supp. 384 (1952); *cf.* *Rider v. Commissioner*, 200 F.2d 524 (8th Cir. 1952) (math professor writing math books); *Goldsmith v. Commissioner*, 143 F.2d 466, 467 (2d Cir.), *cert. denied*, 323 U.S. 774 (1944) (self-proclaimed playwright, even though he only wrote one play; thus produced ordinary income when sold for a motion picture).

27. 339 F.2d 661 (Ct. Cl. 1964).

and milk his cows, feed his neighbor's hogs, and do what was required of him in connection with the sale of these lots. He was not a very busy man. . . ."<sup>28</sup> But in many cases the taxpayer occupies himself with several endeavors, and the court that attempts to separate his various businesses is faced with a sticky task. Taxpayers have generally advocated the straightforward position that a man can have only one business. If, for example, it is established that the taxpayer is a dentist, he cannot then be in the realty business, and any profits received from the subdivision of land he owns must be afforded capital gains treatment. This approach has (if nothing else) the merit of simplicity; but the courts over the past twenty-five years seem to have gone out of their way to reject it.<sup>29</sup>

While the courts seem definitely to have disapproved the view that a taxpayer can have only one business, they have been considerably less definite in evolving standards by which to segregate the taxpayer's "principal" business or businesses. The result has been a series of decisions exceedingly hard to reconcile. *W. R. Stephens Co. v. Commissioner*<sup>30</sup> involved a car dealer who, during World War II, used twenty-eight automobiles for various business purposes, selling them for nearly new-car prices shortly after V-J Day. The court found that he held cars for two distinct purposes — for company use and for sale; in effect he was in two businesses, and capital gains were denied. Early in 1966 the Supreme Court handed down *Malat v. Riddle*.<sup>31</sup> The taxpayer was a real estate developer who acquired a plot of land with the intention of subdividing and selling it or developing it, depending upon which course appeared to be the most profitable. As it turned out the property was sold. The lower courts ruled that the taxpayer had failed to establish that the property was not held primarily for sale in the ordinary course of business. In support of this decision the Government urged that the Supreme Court adopt the reasoning promulgated by various circuits courts that "a purpose may be 'primary' if it is a 'substantial' one."<sup>32</sup> In a per curiam opinion the Court rejected this definition merely stating, "We hold that, as used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'"<sup>33</sup>

28. *Id.* at 663.

29. *Ackerman v. United States*, 335 F.2d 521 (5th Cir. 1964); *Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938); see also *Thompson v. Commissioner*, 322 F.2d 122 (5th Cir. 1963); *Mathews v. Commissioner*, 317 F.2d 360, 361 (6th Cir. 1963); *Jerome S. Murray*, 24 CCH Tax Ct. Mem. 762, 781 (1965).

30. 199 F.2d 665 (8th Cir. 1952).

31. 383 U.S. 569 (1966); see also *Hollywood Baseball Ass'n v. Commissioner*, 352 F.2d 350 (1965), *vacated in light of Malat*, 383 U.S. 824 (1966).

32. *Id.* at 571.

33. *Id.* at 572.



It would seem then that a rather large group of cases has been given new standing. *Margolis v. Commissioner*<sup>34</sup> is typical. In *Margolis* the taxpayer was a real estate dealer who subdivided and sold a plot of land. As this purchase was considered incidental to his business and for the avowed purpose of development of income property, capital gains were allowed. In *United States v. Hess*<sup>35</sup> the same principle was applied to compressed air cylinders. Finally, there is a line of cases allowing funds received from the culling out of over-age animals to be taxed at capital gains rates.<sup>36</sup> It is hard to fathom out the Supreme Court's reasoning or to grasp how the sale of culls — accounting for perhaps twenty-five per cent of a farmer's income — can be treated as separate from his business. Possibly the courts feel that a money making activity incidental to the principal endeavor merits different treatment than an activity of the same magnitude entirely divorced from the taxpayer's principal occupation. The rationale behind such a distinction appears somewhat nebulous, at best. In fact, it is entirely possible that this line of reasoning may be inherent in the background of Judge Wright's decision in the *Stern* case. Stern was principally a publisher, but he was also a writer, and writing several short stories, two screen plays and a novel could have been deemed incidental to his true business — in which case the court would be correct in allowing him capital gains. However, if this rationale forms any part of the decision in the *Stern* case, it remains completely unverbilized.

The amount of time spent on the activity is by itself a poor test of whether the taxpayer is engaging in a hobby or a business. As a standard, it is unsound in theory; and in practice, establishing a cut-off point beyond which the taxpayer can be said to be operating a business, rather than engaging in a hobby, is next to impossible. Indeed, the somewhat related hobby-loss cases only mention this factor when the taxpayer has spent full time on his hobby;<sup>37</sup> at that point it becomes an indication that he is operating a business. Conversely, Judge Wright speaks of a small or insignificant amount of time spent on the hobby;

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34. 337 F.2d 1001 (9th Cir. 1964); *accord*, F. B. Tippins, Jr., 24 CCH Tax Ct. Mem. 521 (1965); *Hufford v. United States*, 65-2 U.S. Tax Cas. ¶ 9765 (E.D. Wash. 1965).

35. 341 F.2d 444 (10th Cir. 1965).

36. *Cedarburg Fox Farms, Inc. v. United States*, 283 F.2d 711 (7th Cir. 1960); *United States v. Bennett*, 186 F.2d 407 (5th Cir. 1951); *Albright v. United States*, 173 F.2d 339 (8th Cir. 1949); *Moore v. United States*, 65-2 U.S. Tax Cas. ¶ 9695 (N.D. Miss. 1965); *accord*, *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683, 687-88 (8th Cir. 1965); *cf.* *Gottfredson v. Commissioner*, 217 F.2d 673 (6th Cir. 1954), *cert. denied*, 350 U.S. 846 (1955); *Fox v. Commissioner*, 198 F.2d 719 (4th Cir. 1952).

37. See notes 129 and 142 *infra* and accompanying text.

but no one speaks of the great middle ground between "full" time and "insignificant" time. Thus it can only be concluded that this test is best used in connection with a series of subjective factors, or perhaps to tip the balance in the close case. If the court believes the taxpayer's activity is his primary business, its opinion will be fortified if twenty-five to fifty per cent of the taxpayer's time is spent on this activity. However, if in the court's eyes the taxpayer's activity more closely resembles a hobby, the same percentages become merely a balancing factor.<sup>38</sup>

The most helpful of Judge Wright's tests is the third — that is, the very nature of the venture should insure that it will be profitless until the ultimate recovery (now sought to be taxed at capital gains rates) is made; no series of small earnings — so often regarded as negating an author's claim that he writes for pleasure<sup>39</sup> — will bar capital gains treatment. This test is not completely valid, however, because it fails to differentiate between the professional wildcatter and the amateur adventurer, neither of whom will realize a profit until a find is made. Nevertheless, compliance with this test adds color to the taxpayer's claim, and so, despite its weakness, it cannot prudently be ignored. Moreover, a recent panel of the Tax Court has proposed a novel test.<sup>40</sup> In a case where a taxpayer sold off a series of lots in a passive manner, Judge Whitney, speaking for the panel, reasoned that a property owner selling lots in a lackadaisical fashion could not be in the real estate business. But the fact is that the bankruptcy courts are full of passive companies, and much of the space in any volume of legal reports is taken up with efforts to avoid the statute of limitations — again the result of "passive" conduct. Thus, the court is in effect saying that a sloppy real estate developer should receive capital gains treatment (perhaps on the theory that he needs it to realize a fair return), while an efficient operator must be content with what he has left after the ordinary income tax has taken its bite.

Finally, mention must be made that the courts prefer to examine a multitude of factors, but never state which are controlling — a technique which seems to have originated with the Federal Communications Commission in its comparative licensing cases. The tax

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38. *Snell v. Commissioner*, 97 F.2d 891, 892 (5th Cir. 1938), "The word, notwithstanding disguise in spelling and pronunciation, means business; it implies that one is kept more or less busy. . . ."

39. This argument was raised in *Stern v. United States*, 164 F. Supp. 847, 851 (E.D. La. 1958), *aff'd per curiam*, 262 F.2d 957 (5th Cir.), *cert. denied*, 359 U.S. 969 (1959), and in *Herwig v. United States*, 122 Ct. Cl. 493, 495-96, 518, 105 F. Supp. 384, 389 (1952).

40. *F. B. Tippins, Jr.*, 24 CCH Tax Ct. Mem. 521, 526 (1965). On almost identical facts the Ninth Circuit several years ago went the other way. *Ehrman v. Commissioner*, 120 F.2d 607 (9th Cir.), *cert. denied*, 314 U.S. 668 (1941).

courts, at least when attempting to define "business,"<sup>41</sup> or when dealing with "thin-incorporation"<sup>42</sup> or "hobby losses," apparently have been bitten by the same bug.<sup>43</sup> While the individual considerations enumerated in these cases are of no moment in dealing with the sale of an underwater mine or recovered treasure, still the courts have, in adopting this approach, served notice that all such factors may be considered when they seek to determine a taxpayer's true business. And the more subtle courts have also indicated that any attempt to apply "a color test to match element by element" and so avoid classification as a business is doomed to failure.<sup>44</sup>

How then can a taxpayer prove that he is an amateur explorer, or, alternatively, that he is not in the "business" of discovering treasures at sea? Frankly, there is no assurance that he can. This is the failure of all multiple-factor tests — no matter what is done, there is no guaranty that the court will not balance the factors in a manner unfavorable to the taxpayer. Thus, in the last analysis, the taxpayer is guided by little more than an intelligent guess.<sup>45</sup>

Nevertheless, prudence dictates that certain guideposts be followed. For one thing, the adventurers must establish that their principle business is not underseas exploration. Standing alone, a showing that they are, say, a group of dentists, will not carry the day. However, this factor takes on weight when accompanied by other indicia

41. *United States v. Temple*, 355 F.2d 67, 68 (5th Cir. 1966); *Winberg v. Commissioner*, 326 F.2d 157, 160-64 (9th Cir. 1963); *Thompson v. Commissioner*, 322 F.2d 122, 125-27 (5th Cir. 1963); *Miller v. United States*, 339 F.2d 661, 663-64 (Ct. Cl. 1964); *F. B. Tippins, Jr.*, 24 CCH Tax Ct. Mem. 521 (1965); *Walter F. Tellier*, 22 CCH Tax Ct. Mem. 1062, 1069 (1963), *aff'd*, 342 F.2d 690 (2d Cir. 1965), *cert. denied*, 383 U.S. 687 (1966); see 3b MERTENS, FEDERAL INCOME TAXATION § 22.15, at 75 (1958).

42. *Foresum, Inc. v. Commissioner*, 348 F.2d 1006 (6th Cir. 1965); *Motel Co. v. Commissioner*, 340 F.2d 445, 446 (2d Cir. 1965); *McSorley's, Inc. v. United States*, 323 F.2d 900, 902 (10th Cir. 1963); *Wilbur Sec. Co. v. Commissioner*, 279 F.2d 657, 662 (9th Cir. 1960); *Kruse Grain & Milling Co. v. Commissioner*, 279 F.2d 123, 125-26 (9th Cir. 1960); *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957); *Rowan v. United States*, 219 F.2d 51, 55 (5th Cir. 1955); *Old Dominion Plywood Corp.*, 25 CCH Tax Ct. Mem. 678, 693-95 (1966); see also ALLI, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 400-37 (1958); Weis, *The Labyrinth of the Thin Corporation*, 40 TAXES 568 (1962).

43. See *Du Pont v. United States*, 234 F. Supp. 681 (D. Del. 1964); *cf. Brown Shoe Co. v. United States*, 370 U.S. 294, 329, 331-32, 334, 344 (1962); see also *United States v. Drum*, 368 U.S. 370, 382-86 (1962). In *District of Columbia v. General Motors Corp.*, 336 F.2d 885 (D.C. Cir. 1964), when the court applied a single test rather than looking to a three-pronged standard to determine local franchise taxes, the Supreme Court was quick to grant certiorari and reverse. 380 U.S. 553 (1965).

44. *Thompson v. Commissioner*, 322 F.2d 122, 126 (5th Cir. 1963).

45. The multi-factor approach due to its uncertainty has not been received kindly in all quarters. *Commissioner v. Pontchartrain Park Homes*, 349 F.2d 416 (5th Cir. 1965). In *Commissioner v. Pfaudler Inter-American Corp.*, 330 F.2d 471, 474 (2d Cir. 1964), involving the question where a sale took place, the court made specific reference to this problem: "by contrast, the 'substance of the sale' test set out in Treasury Regulation § 1.861-7 (1957) — which provides that 'all factors of the transaction . . . will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred' — is vague and uncertain."

of an amateur status — failure to incorporate the venture, absence of a profit motive, or a passive approach to the business aspects of the operation. And in a treasure hunting venture this test can be easily met; for all that is really required is that all members be employed,<sup>46</sup> and that none be employed in mineral exploration or salvage operations. The second major indicator — the amount of time spent on the activity — is more difficult to comply with; for the tendency in these projects is to go overboard and spend almost as much time on the hobby as on the parties' principal businesses. However, with the exercise of reasonable restraint, such compliance is not impossible. If the activities are limited to a summer — or even two or three summers, especially if the family is taken along and the project turns into a vacation — the Commissioner will have difficulty supporting his contention that sufficient time was put in to make the venture a business.<sup>47</sup> All other tests are minor by comparison, and serve only to color the activity for or against the taxpayer.

But even if all the tests mentioned are met, the Commissioner has indicated, by his treatment of copyright and patent cases, that he will be only too happy to make a test case out of the type of situation under consideration. And while the Commissioner might not prevail in the lower federal courts, he would stand a good chance of successfully arguing that every serious exploration project is to be treated as a business<sup>48</sup> — at least to the extent of denying it capital gains treatment — before the Supreme Court. Whether the Court would grant certiorari in this type of case is, of course, another matter; but, in any event, a test case can be an extremely expensive and trying experience — perhaps worse in the long run than paying the ordinary income tax.

Only in the situation where the undertaking must either qualify as an amateur operation, or be taxed at ordinary income rates, is an amateur status desirable; in the majority of cases, it will be to the taxpayer's advantage to operate the venture as a business. For example, merely by qualifying as a business, a corporation organized to locate and develop a mineral deposit is entitled to deduct certain exploration<sup>49</sup>

46. When a person is retired any profit making activity, however small, may be classified as his business. *Miller v. United States*, 339 F.2d 661, 663 (Ct. Cl. 1964).

47. The stringent position taken by the Commissioner in denying expenses connected with conventions or foreign travel as lacking a business purpose is most helpful at this point — at least as far as arguments by analogy are useful. See Rev. Rul. 63-266, 1963-2 CUM. BULL. 88; *Patterson v. Thomas*, 289 F.2d 108 (5th Cir. 1961); *Alexander P. Reed*, 35 T.C. 199 (1960).

48. *United States v. Zacks*, 375 U.S. 59 (1963); *cf. United States v. Midland-Ross Corp.*, 381 U.S. 54, 56-57 (1965); *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); *Corn Prods. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955); *accord, Merton E. Farr*, 11 T.C. 552 (1948), *aff'd sub nom. Sloan v. Commissioner*, 188 F.2d 254 (6th Cir. 1951).

49. The first \$100,000 of exploration expenditures may be deducted from current net income, or from future income. §§ 615(a); 617.

and development<sup>50</sup> costs from its future or current profits, and to establish a depletion schedule,<sup>51</sup> and once the corporation is under way, the shareholders may bail out at capital gains rates.<sup>52</sup> In comparison, it is questionable whether a venture not classed as a business would be allowed anything other than the depletion allowance. Moreover, incorporation allows the shareholder-employees to participate in qualified pension, profit sharing, stock bonus<sup>53</sup> or group life insurance plans. Or, should the shareholders wish to terminate the operation, maximum gains may be realized by selling the corporation to a tax-exempt charity,<sup>54</sup> which frequently is willing to offer more than the going market price,<sup>55</sup> and the 1964 income-averaging provisions further soften the tax blow.<sup>56</sup>

## II. THE WESTERN HEMISPHERE TRADE CORPORATION

Generally, any corporation incorporated in the United States, and selling exclusively outside the United States but within the Western Hemisphere, may elect to be taxed under section 922.<sup>57</sup> Of course, the principal disadvantage to corporate organization is that the corporation itself is taxed at the corporate income tax rate, and then the shareholders are in effect taxed again on the distributed profits. But even here, substantial savings are made possible by electing to utilize either of two corporate forms: (1) the Western Hemisphere Trade Corporation, or (2) the Subchapter S corporation.

50. Section 616(a).

51. Almost every mineral receives some depletion allowance. While oil and gas are allowed 27½% (§ 613(b)(1)), and sulfur and uranium 23% (§ 613(b)(2)(A)), the largest number fall in the 15% bracket (§ 613(b)(6)). No allowance is given to minerals taken from sea water or from other inexhaustible sources. § 613(b)(6)(B).

52. Redemptions, tax-free property distributions, mergers, and stock-distributions covered by Subchapter C are outside the scope of this article. See generally BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1966).

53. Sections 401, 105-06.

54. *Commissioner v. Brown*, 380 U.S. 563 (1965).

55. *Id.* at 588 (Goldberg, J., dissenting). The Commissioner has announced that the Service will continue to challenge all sales at more than fair value. Tech. Info. Release No. 768, 1965 CCH ¶ 6739.

56. Capital gain, as well as ordinary income, may be averaged. §§ 1302(a)(2), 1302(d); see also *infra* n.147.

57. See, e.g., Brudno, *The Practical Aspects of Incorporating and Doing Business Abroad*, U. So. CAL. 1962 TAX INST. 345; Crawford, *A Review of United States Taxation of International Operations*, N.Y.U. 18TH INST. ON FED. TAX 263 (1960); Graubart, *Pitfalls of Western Hemisphere Trade Corporations*, 38 TAXES 863 (1960); Kalish, *Tax Considerations in Organizing for Business Abroad*, 44 TAXES 71 (1966); McClure, *Foreign Operations of Extractive Industries*, N.Y.U. 18TH INST. ON FED. TAX 601 (1960); Seghers, *The Western Hemisphere Trade Corporation — What It is and How to Use it to Advantage*, 42 TAXES 582 (1964); Wender, *Use of Tax Haven Corporations and Western Hemisphere Trade Corporations*, U. So. CAL. 1959 TAX INST. 253.

Section 922 was originally designed to allow American extracting firms<sup>58</sup> burdened with high wartime taxes to compete with their foreign counterparts;<sup>59</sup> but like so many wartime measures, this one has, in modified form, endured. It allows a qualifying corporation an additional deduction equal to  $1\frac{1}{4}\%$  of its net profit. To illustrate, assume that a corporation, "Sea Treasures", qualifies under section 921, and that it has a net profit of 1,000,000 dollars after deducting its depletion allowance. By virtue of section 922, the tax rate drops from 48 to 33.4 per cent, computed as follows:

$$\$1,000,000 - (1\frac{1}{4}\% \times \$1,000,000) = \$708,334$$

$$\$708,334 \times 22\% + (\$708,334 - \$25,000) \times 26\% = \\ \$333,500.32 \text{ or } 33.4\%$$

It will be noted that since the first 25,000 dollars of earnings is taxed at only 22 per cent, this deduction becomes more and more valuable as the net profit declines. Thus, had Sea Treasures earned 100,000 dollars instead of 1,000,000 dollars, its tax rate would be 27.5 per cent.

To qualify for such favorable tax treatment, a corporation must meet four tests: (1) it must be a domestic corporation, incorporated in a state or territory;<sup>60</sup> (2) it must do substantially all of its business "in countries located in North, Central or South America, or in the West Indies"<sup>61</sup> except Bermuda;<sup>62</sup> (3) it must receive ninety-five per cent of its income from sources outside the United States,<sup>63</sup> and (4) it must receive ninety per cent of its gross income from a trade or business<sup>64</sup> — a proviso inserted to prevent investment companies from operating out of South American countries in order to reduce their

58. S. REP. NO. 1631, 77th Cong., 2d Sess. 111 (1942); Baker & Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales*, 22 TUL. L. REV. 229, 237-40 (1947); Flynn, *Western Hemisphere Trade Corporations: Quo Vadis?*, 12 TAX L. REV. 413, 416-17 (1957); Raskind, *The Western Hemisphere Trade Corporation: A Functional Perspective*, 16 VAND. L. REV. 1, 5 (1962); Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 836-37 (1956); Note, *Western Hemisphere Trade Corporation*, 53 GEO. L.J. 802, 803 (1965).

59. S. REP. NO. 1631, 77th Cong., 2d Sess. 32 (1942). This argument was raised as early as 1921. 61 CONG. REC. 5186. At that time an amendment was written into the House bill exempting from United States tax the foreign income of domestic corporations receiving 80% of their income from foreign sources. H.R. REP. NO. 350, 67th Cong., 1st Sess. 8 (1921). However this amendment — primarily because it did not exclude income from banking and other investment activities — ran into trouble in the Senate, 61 CONG. REC. 5883-86, 6489-94, 6540-43, 6546-47 (1921), and was not included in the Senate bill, nor was it restored in conference. H.R. REP. NO. 486, 67th Cong., 1st Sess. 14-15 (1921).

60. Sections 921, 7701(a)(4), 7701(a)(9).

61. *Ibid.*

62. I.T. 3990, 1950-1 CUM. BULL. 57.

63. Section 921(1).

64. Section 921(2); *Towne Sec. Corp. v. Pedrick*, 53-2 U.S. Tax Cas. ¶ 9585 (S.D.N.Y. 1953); see also Note, *Western Hemisphere Trade Corporations*, 53 GEO. L.J. 802, 804-05 (1965).

tax loads. But this section, relatively straightforward as it is, would seem plainly to exclude Sea Treasures. For by definition, " 'Western Hemisphere Trade Corporation' means a domestic corporation all of whose business (other than incidental purchases)<sup>65</sup> is done in any country or countries in North, Central or South America",<sup>66</sup> and even if Sea Treasures sold its entire output in Mexico, it would still have purchased its equipment and hired its employees in the United States, and run its operation from there.

However, in a series of cases culminating in *Commissioner v. Pfaudler Inter-American Corp.*,<sup>67</sup> the courts have refused to hold the statute applicable only to corporations whose business is conducted primarily outside the United States. They have instead taken the view that as the United States is clearly within the Western Hemisphere, all that is required is that ninety-five per cent of the corporation sales<sup>68</sup> take place within the Western Hemisphere but outside the United States. And in view of the unanimity of decision from the Second<sup>69</sup> and Seventh<sup>70</sup> Circuits and the Court of Claims,<sup>71</sup> the Commissioner has announced that the Service will no longer contend that a Western Hemisphere Trade Corporation must conduct its business completely outside the United States.<sup>72</sup> But what of the operation carried on outside the territorial limits of any country — for example, twelve miles

65. The regulations provide that incidental purchases are minor or nonrecurring and not in excess of "5 percent of the corporation's gross receipts from all sources for such taxable year." Treas. Regs. §§ 1.921-1(a)(1), 1.921-1(b) example 2 (1957); Rev. Rul. 61-195, 1961-2 CUM. BULL. 133; Rev. Rul. 59-356, 1959-2 CUM. BULL. 177; G.C.M. 25131, 1947-2 CUM. BULL. 85. However, the court of claims held purchases equal to 16.9% of gross receipts "not so substantial as to deprive the taxpayer, otherwise eligible, of the right to the credit." *Otis Elevator Co. v. United States*, 356 F.2d 157 (Ct. Cl. 1966). No appeal was taken by the Government from this decision.

66. Section 921.

67. 330 F.2d 471, 474 (2d Cir. 1964); *Commissioner v. Hammond Organ W. Export Corp.*, 327 F.2d 964, 966 (7th Cir. 1964); *Frank v. Internat'l Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962); *A. P. Green Export Co. v. United States*, 151 Ct. Cl. 628, 633-34, 284 F.2d 383, 386 (1960); *Babson Bros. Export Co.*, 22 CCH Tax Ct. Mem. 677 (1963); *Pan American Eutectic Welding Alloys Co.*, 36 T.C. 284, 291 (1961); *Barber-Greene Americas, Inc.*, 35 T.C. 365, 387 (1960).

68. *Commissioner v. Pfaudler Inter-American Corp.*, 330 F.2d 471, 474 (2d Cir. 1964); *Commissioner v. Hammond Organ W. Export Corp.*, 327 F.2d 964, 966 (7th Cir. 1964); *A. P. Green Export Co. v. United States*, 151 Ct. Cl. 628, 284 F.2d 383 (1960); *Pan American Eutectic Welding Alloys Co.*, 36 T.C. 284 (1961); *Barber-Greene Americas, Inc.*, 35 T.C. 365 (1960); *cf. The Exolon Co.*, 45 B.T.A. 844 (1941); *Ronrico Corp.*, 44 B.T.A. 1130 (1941); *East Coast Oil Co.*, 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir.), *cert. denied*, 299 U.S. 608 (1936). See Kraher, *Federal Income Tax Treatment of International Sales of Goods: A Reevaluation of the Title-Passage Test*, 17 TAX L. REV. 235 (1962); Brainerd, *United States Income Taxation of International Sales of Personal Property*, 32 TAXES 359 (1954); Dailey, *The Concept of the Source of Income*, 15 TAX L. REV. 415 (1960).

69. *Commissioner v. Pfaudler Inter-American Corp.*, 330 F.2d 471, 474 (2d Cir. 1964).

70. *Commissioner v. Hammond Organ W. Export Corp.*, 327 F.2d 964, 966 (7th Cir. 1964).

71. *A. P. Green Export Co. v. United States*, 151 Ct. Cl. 628, 284 F.2d 383 (1960); *cf. Otis Elevator Co. v. United States*, 157 Ct. Cl. 339, 301 F.2d 320 (1960).

72. Rev. Rul. 64-198, 1964-2 CUM. BULL. 189.

out at sea? Would a corporation so operating still qualify under section 921? Within the Gulf there is no problem, for since all of the floor is claimed by the United States and much of it is also claimed by several other countries, the corporation should qualify no matter who is deemed sovereign in this area. From a practical standpoint, the corporation should argue that the Gulf is subject to home ownership, for most minerals are given a twenty-three per cent depletion allowance if mined in the United States, in contrast to a fifteen per cent allowance if mined outside it.<sup>73</sup> Therefore, a finding of United States ownership of the mining area will often increase the depletion allowance. However, this is quite apart from any question of qualifying as a Western Hemisphere Trade Corporation. Even in the situation where the company operates off the coast of South America, in unclaimed waters (a possibility nearing reality as deep-sea equipment improves) no significant problem of qualification under section 921 arises. The Service has indicated that all of the Continent (with the exception of British holdings)<sup>74</sup> comes within the purview of this section; and this, coupled with a recent line of cases allowing liberal inclusion, seems to indicate that the corporation need only be domestically incorporated and sell abroad. A company incorporated in Delaware and selling in Argentina would thus qualify

### III. THE SUBCHAPTER S CORPORATION

A corporation, if it meets certain tests, may elect to be taxed under Subchapter S of the Code.<sup>75</sup> Should this election be made, all profits and most losses are passed through the corporation to its shareholders where they are taxed at each individual's regular income tax rate.

Operation as a Subchapter S corporation requires compliance with a series of fairly straightforward tests. At the outset, a partnership or

73. Compare § 613(b)(2)(B) with § 613(b)(6).

74. Included are Greenland (Rev. Rul. 60-307, 1960-2 CUM. BULL. 214), the Bahamas and islands off the coast of Venezuela, The Greater and Lesser Antilles, The Virgin Islands, and Puerto Rico. Rev. Rul. 55-105, 1955-1 CUM. BULL. 94.

75. 72 STAT. 1650, 26 U.S.C. §§ 1371-78 (Supp. II, 1966). Subchapter S came into Title Twenty Six in a rather unusual fashion, as part of the Technical Amendments Act of 1958. It had first been proposed five years earlier by President Eisenhower, who suggested to Congress that corporations with few shareholders be allowed the option of taxation as partnerships, and conversely, that partnerships be afforded the opportunity of taxation as corporations. Only the former proposal — comprising the present Subchapter R — was enacted. Three years later, the House urged repeal of Subchapter R; the Senate Finance Committee not only disagreed, but offered a redrafted version of President Eisenhower's original companion proposal, the previously rejected "corporations-taxable-as-partnerships" bill. The Senate managers prevailed in conference, and Subchapter S came into being. For a more detailed history of Subchapter S see Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1-2 (1965); revised and reprinted in 1966 *Corporate Counsel's Annual* 1019-64 (Matthew Bender Co.). 7 MERTENS, FEDERAL INCOME TAXATION § 41 B. 01 (1962); Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX. L. REV. 453, 457 (1959).



proprietorship must be incorporated since Subchapter S is limited to domestic corporations which are not part of an affiliated group.<sup>76</sup> The corporation must file Form 2553 with the district director in the final month of the corporation's taxable year or during the first month of the next year.<sup>77</sup> Once a timely election is made it remains in effect until revoked or terminated. However, if an election is not timely it is the same as if no election had been filed. Therefore, the attempted election for each succeeding year fails.<sup>78</sup> Less than eleven individual,<sup>79</sup> non-alien<sup>80</sup> shareholders<sup>81</sup> are required. While a husband and wife holding stock as community property,<sup>82</sup> as joint tenants, tenants by the entireties or tenants in common are counted as one shareholder,<sup>83</sup> nonetheless each individual must file a written consent to the election<sup>84</sup> — for, in contrast to other provisions of the Code,<sup>85</sup> a single holdout destroys the election.<sup>86</sup> Additionally, the corporation may not have more than one class of stock<sup>87</sup> or receive more than twenty per cent of

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76. Section 1371(a).

77. Section 1372(c)(1); Treas. Reg. § 1.1372-2(a) (1960).

78. Joseph W. Feldman, 47 T.C. 329 (1966).

79. Section 1371(a)(1)-(2).

80. Section 1371(a)(3).

81. Section 1371(a)(1). All shareholders must be individuals, usufructs or estates. Corporations, partnerships, trusts, or voting trusts are not permissible shareholders; although nominees, agents, guardians or custodians are. Treas. Regs. §§ 1.1371-1(d)(1), 1.1371-1(e) (1960); Rev. Rul. 65-90, 1965-1 CUM. BULL. 428; Rev. Rul. 64-249, 1964-2 CUM. BULL. 332. In addition, the election must be filed by the executor or fiduciary (corporation in bankruptcy). Herbert Levy, 46 T.C. 531 (1966); Lewis Bldg. & Supplies, Inc., 25 CCH Tax Ct. Mem. 844 (1966). In *Old Virginia Brick Co.* 44 T.C. 724 (1965), *aff'd*, 367 F.2d 276 (4th Cir. 1966), the court ruled that a probate held open long after the administrative activities have been performed can be deemed terminated and a trust substituted in its place. Care must be taken that the magic number ten is not exceeded by a guardian holding stock for several beneficiaries as the beneficiary, not the guardian, is considered the shareholder. Treas. Reg. § 1.1371-1(d) (1960). Two years ago the Commissioner granted an exception. He ruled that special stock issued to the Federal Housing Commissioner as required by 24 C.F.R. § 207.18(c) (1965) will not terminate an election. Rev. Rul. 64-309, 1964-2 CUM. BULL. 333.

82. Section 1371(c)(1).

83. Section 1371(c)(2).

84. Treas. Reg. § 1.1372-3(a) (1964). These rules are strictly interpreted. *Simons v. United States*, 208 F. Supp. 744 (D. Conn. 1962); Joseph W. Feldman, 47 T.C. 329 (1966); M. H. McDonald, 24 CCH Tax Ct. Mem. 647, 650 (1965); J. William Frentz, 44 T.C. 485 (1965); William Prestcoe, 40 T.C. 195 (1963). Consent once given is binding and may not be withdrawn after the corporation files its 2553 form. Treas. Reg. § 1.1372-3(a) (1960). However, an election given by a spouse does not alleviate the requirement that the executor file an election, even though the executor is the surviving spouse. *Lewis Bldg. & Supplies*, 25 CCH Tax Ct. Mem. 844 (1966). And should the corporation be in receivership, the trustee, not the shareholders, must make the election. Herbert Levy, 46 T.C. 531 (1966). In addition a custodian cannot make an election unless he is also the minor's guardian, Rev. Rul. 66-116, 1966 INT. REV. BULL. No. 19, 15; *cf.* Treas. Reg. § 1.761-1(a)(2)(iv)(a) (1956) (partnership electing not to be taxed under Subchapter K); and § 1501 (corporations filing consolidated returns).

85. Sections 333(c)(1), 337(d); *cf.* § 1361(f).

86. Section 1372(a). Subsection (f) of the 1954 bill would have allowed an election if 80% of the shareholders consented. S. REP. No. 1622, 83d Cong., 2d Sess. 454-55 (1954).

87. Section 1371(a)(4). This does not mean merely that the corporation may not issue preferred and common; it may not issue two types of common. "Thus, a

its income "from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities,"<sup>88</sup> nor may it derive more than eighty per cent of its gross receipts from sources outside the United States.<sup>89</sup> Because of this latter requirement a Subchapter S corporation is prevented from also being a Western Hemisphere Trade Corporation.<sup>90</sup> The election is terminated automatically if any of the above conditions are not met;<sup>91</sup> the only penalty incurred as such is that the corporation may not make a new election for five years,<sup>92</sup> and for good cause the Commissioner may waive this provision.<sup>93</sup> However, the corporation will be taxed under the normal tax rates during the time it was disqualified, and this in itself often is disastrous.

Each provision has on occasion caused difficulty. The requirement that the corporation have only one class of stock, however, has become especially burdensome. For various reasons — perhaps to give some shareholder preferential treatment; perhaps as the first step in an intra-family transfer of wealth; perhaps due to ignorance — Subchapter S corporations have been incorporated with inordinately high debt ratios. They are said to be thinly incorporated. Unfortunately, until late 1966, once the debt was found to be cancelled equity, the regulations required that it be deemed a second class of stock and the election terminated. Although the reason for restricting Subchapter S corporations to one class of stock was somewhat speculative — little mention being made of the problem in the committee reports — the generally accepted version is that more than one class of stock would make the allocation of earn-

difference as to voting rights, dividend rights, or liquidation preferences . . . will disqualify a corporation. . . ." Treas. Reg. § 1.1371-1(g) (1966).

88. Section 1372(e)(5). There has been considerable dissension in this area. See Temple N. Joyce, 42 T.C. 628 (1964), and the resulting 1966 legislation adding § 1372(e)(5)(B) to the Code. H.R. REP. NO. 1238, 89th Cong., 2d Sess. 8, 18-19 (1966). See also Valley Loan Ass'n v. United States, 258 F. Supp. 673 (D. Colo. 1966), invalidating Treas. Reg. § 1.1372-4(b)(5)(ii); and see also Rev. Rul. 65-91, 1965-1 CUM. BULL. 431; Rev. Rul. 65-83, 1965-1 CUM. BULL. 430; Rev. Rul. 65-40, 1965-1 CUM. BULL. 429.

89. Section 1372(e)(4). Care must be taken to insure that any recovery is sold in the United States to prevent an involuntary termination of the election. The sale is said to occur where title passes. Commissioner v. East Coast Oil Co., S.A., 85 F.2d 322 (5th Cir.), cert. denied, 299 U.S. 608 (1936); The Exolon Co., 45 B.T.A. 844 (1941), acq. 1947-2 CUM. BULL. 2.

90. By definition Western Hemisphere Trade Corporations receive 95% of their gross income from sources outside the United States. § 921(1). This restriction is not entirely fair, for, without apparent justification, different treatment is extended to corporations and individuals than to Subchapter S corporations.

91. Sections 1372(e)(1), 1372(e)(4), 1372(3)(5). The election may also be revoked if the procedure set out in § 1372(a)(2) is followed. See Alfred N. Hoffman, 47 T.C. 218 (1966).

92. Section 1372(f).

93. Treas. Reg. §§ 1372-5(a) (1960), 1.1372-5(c) (1964).

ings and profits too complicated.<sup>94</sup> When the proposed regulations appeared they added the controversial requirement.<sup>95</sup> And this portion of the regulations became final without change.

Four cases have dealt with this regulation; two within the past year. In *Catalina Homes, Inc.*<sup>96</sup> two principal shareholders proportionally advanced funds sufficient to give the corporation a seven to one shareholder debt-equity ratio. These loans were not represented by notes, nor did they have a fixed maturity date. And while interest was specified at five per cent, it was only payable at the discretion of the board of directors. The conclusion was easily reached that these were not, in fact, loans but, instead, contributions to capital. Once this finding was made the validity of section 1.1371-1(g) could have been raised. However, counsel, at least in his brief, did not argue the point; nor did the Tax Court see fit to raise the question on its own motion. The court merely found that the purported loans differed from the common stock in that the loans were entitled to five per cent interest and a liquidation preference while the common was not. Therefore, the loans were deemed a second class of stock.

In *Henderson v. United States*,<sup>97</sup> the district court after first finding that purported debt was in fact equity, summarily concluded that a second class of stock had been issued. Even though counsel argued the invalidity of section 1.1371-1(g), the court swept aside the question, merely holding that "the instrument received by Frederick Henderson from Henderson Mining Company in exchange for his advances to that corporation constituted a second class of stock. Such being the case, the Henderson Mining Company, Inc. did not qualify as a small business corporation. . . ."<sup>98</sup>

Last summer, the Tax Court, sitting en banc met the question head on. Unfortunately, views in *W. C. Gamman*,<sup>99</sup> were quite fragmented: two concurring opinions, sponsored by five judges, and a dissenting opinion representing five more followed by majority opinion. The

94. See S. REP. No. 1622, 83d Cong., 2d Sess. 453 (1954) :

The corporation may have only one class of stock outstanding. No class of stock may be preferred over another as to either dividends, distributions, or voting rights. If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an adjustment, however, would be extremely difficult when there had been a transfer of common stock in the interim.

95. Proposed Treas. Reg. § 1.1371-1(g), 24 Fed. Reg. 1991 (1959).

96. 23 CCH Tax Ct. Mem. 1366 (1964).

97. 245 F. Supp. 782 (M.D. Ala. 1965).

98. *Id.* at 786.

99. 46 T.C. 1 (1966).

court held at the outset that "we do not believe the notes can be considered true debt obligations. . . ." <sup>100</sup> The majority opinion, while somewhat vague, seems to attack the question of the validity of section 1.1371-1(g) along two broad avenues. First, it considers the Commissioner's argument that debt found to be risk capital can in fact only be stock. However, the regulation was not this specific. It allowed some leeway in that it provided: "[I]f an instrument purporting to be a debt obligation is *actually stock*, it will constitute a second class of stock." <sup>101</sup> Taking the words "*actually stock*" at face value, the court implies, if in fact it does not hold, that the company could not, under the local corporation law, have a second class of stock without first taking further formal action (such as amending its charter or by-laws). As the corporation could not have a second class of stock, the disallowed debt was not actually stock as defined in the regulation. Thus, when the Commissioner interprets the regulation in such a manner that he can create a second class of stock when a second class of stock cannot legally exist, the regulation is invalid.

The alternate holding rests on the traditional argument that the regulations go beyond the intent of Congress. The court examines the legislative history of Subchapter S and finds little said regarding the requirement that a corporation must not have more than one class of stock. It could find no indication that a pseudo-debt obligation must be treated as a second class of stock. As a matter of fact, it indicates that a contrary presumption would be in order. If a stockholder were specifically prohibited from loaning funds to a Subchapter S corporation, the Government's position would have some merit. However, Congress intended shareholders to loan funds to Subchapter S corporations for indebtedness owed a shareholder by the electing corporation, and this is specifically provided for in section 1376.

Judge Withey's concurring opinion elaborates the majority's first point — that a second class of stock must actually exist before section 1.1371-1(g) applies. Judge Withey would hold that unless the purported debt instrument has sufficient elements of character similar to characteristics generally found in a share of stock, the debt cannot be a second class of stock. And in the instant case, the notes lack sufficient "stock" characteristics:

In the first place, they may be called on demand of the holder; secondly, the interest (which under the thin capitalization cases would be likened to dividends) is payable from the very assets of the corporation if necessary, unlimited by its earnings; and thirdly,

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100. *Id.* at 9.

101. Treas. Reg. § 1.1371-1(g) (1960). (Emphasis added.)

the amount of earnings to be derived from the capital invested (interest) is an amount fixed by a percentage of the principal (or investment) which is required to be paid at fixed intervals. I know of no State which permits the issuance of any class of stock with these characteristics.<sup>102</sup>

The second concurring opinion sponsored by Judge Dawson would go beyond the majority and hold the regulation to be invalid in all circumstances. He argues that the recent *Catalina Homes* and *Henderson* decisions throw a cloud over any type of loan from stockholder to Subchapter S corporation. This is contrary to the intent of Congress. The requirement of a single class of stock was imposed to avoid the complex rules of allocation and, as pointed out by the majority, section 1376 specifically allows stockholder debt. Therefore, "the second class of stock doctrine, as stated in the regulations, is inconsistent with the intent of Congress. . . ."<sup>103</sup>

The dissenting opinion is very similar to the first concurring opinion in that the issue turns on where the debt can be classified as stock. However, Judge Raum finds the notes in question to closely "resemble cumulative nonparticipating redeemable preferred,"<sup>104</sup> therefore becoming a second class of stock. While acknowledging that the majority has invalidated the regulation, Judge Raum offers nothing to support its validity.

The fourth decision, again from the Tax Court, *Lewis Bldg. & Supplies, Inc.*<sup>105</sup> merely reaffirms *Gamman*.<sup>106</sup> Both *Henderson* and *Gamman* were appealed. The former to the Fifth and the latter to the Ninth Circuit. After the briefs were filed and oral arguments heard in *Henderson*, the Treasury, on December 28, 1966, amended section 1.1371-1(g) of the regulations. The new provision in effect concedes that thin capitalization is not tantamount to a second class of stock in those situations where the "purported debt obligations are owed solely by the owners of the nominal stock of the corporation in substantially the same proportions as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than as a second class of stock."<sup>107</sup>

In the type of venture under consideration, the election is generally made before operations get under way. However, situations do occur where the venture has been carried on as a partnership for some

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102. 46 T.C. 1, 13 (1966).

103. *Id.* at 13.

104. *Id.* at 14.

105. 25 CCH Tax Ct. Mem. 844 (1966).

106. See Braverman, *Special Subchapter S Situations — Regulations Run Rampant*, 114 U. PA. L. REV. 680, 681-85 (1966); Hewitt, *Some Intriguing Recent Developments in Subchapter S*, 45 TAXES 848 (1966).

107. Treas. Reg. § 1.1371-1(g) (1966).

time before an election is sought. But in any event, the incorporation of a partnership or proprietorship is normally tax-free. The corporation takes the partnership's basis, and since exploration ventures are seldom top heavy with capital, basis problems should be minimal.<sup>108</sup>

#### A. *Earnings and Profits*

The Subchapter S corporation computes earnings and profits in much the same manner as other corporations. On the last day of the electing corporation's year, the earnings and profits are computed and taxed *as if they had been distributed*.<sup>109</sup> It makes no difference, tax-wise, if all or none of the earnings have actually been distributed. Every person who is a shareholder on the last day is required to include in his gross income his share of the corporation's undistributed annual earnings.<sup>110</sup> Accordingly, earnings attributable to stock transferred in the waning days of the corporate year will be taxed to the transferee — though he may hold title for only one day — and not to the transferor.<sup>111</sup> This provision allows a reallocation of family income.

Therefore, assuming Sea Treasures becomes a profitable venture, a certain amount of income splitting can be accomplished through a well-planned "giving" program. For example, owners of Subchapter S stock may in December give their "low bracket" children shares carrying accumulated earnings effectively shifting the tax burden from a high to a low bracket taxpayer. Once it becomes clear that a profit will be realized, a substantial amount of stock may be transferred without incurring any tax liability.<sup>112</sup> However, the Service insists that the gift be bona fide. The regulations warn that the circumstances surrounding a transfer between members of a family will be closely scrutinized,<sup>113</sup> and if it is found that the transfer does not reflect the value of services rendered to the corporation, or that no gift actually was made,<sup>114</sup> the Commissioner may reallocate distributions among family members.<sup>115</sup> Although no case directly on the point has yet arisen,<sup>116</sup>

108. Section 351.

109. Section 1373(b).

110. *Ibid.* However, he cannot claim the dividend exclusion allowed by §§ 34, 37, or 116, except to the extent the corporation is distributing pre-election earnings. Treas. Reg. § 1.1375-2(a) (1964). Should the taxpayer die while the election is in force, his estate will be taxed on all Subchapter S earnings. Rev. Rul. 64-308, 1964-2 CUM. BULL. 176.

111. Treas. Reg. § 1.1373-1(a)(2) (1959).

112. Sections 2503(b), 2521.

113. Treas. Reg. § 1.1373-1(a)(2) (1959).

114. *Ibid.*

115. Section 1375(c). See Plowden-Wardlaw, *Subchapter S and Partnerships as Vehicles Governing Family Business*, N.Y.U. 21ST INST. ON FED. TAX 981 (1963).

116. In Henry D. Duarte, 44 T.C. 193 (1965), a gift of Subchapter S stock from the donor to his minor children was challenged. Rather than becoming a test case the

experience under the partnership provisions<sup>117</sup> and section 482 (reallocation of income among related businesses) insures that while an inter-family gift may be made,<sup>118</sup> the Service will be quick to challenge it should the transaction seem the slightest bit tainted.<sup>119</sup>

One of the novel features of taxation as a Subchapter S corporation is that today's earnings may be retained in the corporation for several years and then distributed as dividends, without a tax being imposed on the shareholders. Like partners, the shareholders are

decision went off on the question whether a gift had actually been made and whether the children received the dividends purportedly paid on the shares in question.

117. Treas. Reg. § 1.704-1(e) (iii) (1956).

118. Commissioner v. Culbertson, 337 U.S. 733, 745-48 (1949); Visintainer v. Commissioner, 187 F.2d 519 (10th Cir.), cert. denied, 342 U.S. 858 (1951); Curtis A. Herberts, 10 T.C. 1053 (1948); James T. Pettus, 45 B.T.A. 855 (1941); Edward H. Heller, 41 B.T.A. 1020 (1940), aff'd sub nom. Ehrman v. Commissioner, 120 F.2d 607 (9th Cir.), cert. denied, 314 U.S. 668 (1941); see Miller v. Commissioner, 183 F.2d 246 (6th Cir. 1950). See also Alexandre, *The Corporate Counterpart of the Family Partnership*, 2 TAX L. REV. 493, 494-95 (1947); Eustice, *Contract Rights, Capital Gain, and Assignment of Income — the Ferrer Case*, 20 TAX L. REV. 1, 34-36 (1964); Mannheim, *Income Tax Status of Gifts of Family Corporation Stock*, 25 TAXES 604, 608 (1947). It is interesting to note that while H.R. Rep. No. 9662, 86th Cong., 1st Sess. (1959), would have made substantial changes in Subchapter K, section 704(e) was left unchanged. S. REP. No. 1616, 86th Cong., 2d Sess. 114 (1960).

119. The Commissioner was successful in this challenge of intra-family gifts. Pflugardt v. United States, 310 F.2d 412 (7th Cir. 1962); Spiesman v. Commissioner, 260 F.2d 940 (9th Cir. 1958); Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958); Anderson v. Commissioner, 164 F.2d 870 (7th Cir. 1947); Bradshaw v. Commissioner, 150 F.2d 918 (10th Cir. 1945); Grant v. Commissioner, 150 F.2d 915 (10th Cir. 1945); Ludwig Bendix, 14 T.C. 681 (1950); R. C. Coffey, 1 T.C. 579 (1943), aff'd, 141 F.2d 204 (5th Cir. 1944); cf. Gouldman v. Commissioner, 165 F.2d 686 (4th Cir. 1948); see Surrey, *Family Income and Federal Taxation*, 24 TAXES 980, 985 (1946), where it is suggested that the Treasury is justified in looking to the family as a single tax unit.

The surest way to avoid question is to transfer ownership to a trust. However, care must be taken to insure that the trust is completely cut off from any *incidenta* of control by the donor. Leeb v. Jarecki, 156 F. Supp. 6, 11 (N.D. Ill. 1957). To insure that the gift will qualify under both the income and estate tax provisions care must be taken in drawing up the trust agreement that: (1) The donor does not retain a power of disposition over income or corpus; nor retain the power to select investments; (2) neither the income nor the corpus can revert to the donor; (3) the trust is not revocable; and (4) the donor does not have the power to replace adverse trustees, except in accordance with definite prescribed standards. See H.R. REP. No. 1231, 86th Cong., 2d Sess. 17-19, 69-72 (1960), and S. REP. No. 1616, 86th Cong., 1st Sess. (1959). Ill-fated H.R. 9662 was twice passed over by the Senate. See H.R. 9662, 86th Cong., 2d Sess. 28, 31 (1960); 106 CONG. REC. 14667, 16745 (1960).

In addition, the minor must have the power to dispose of the trust by will and the corpus must be distributed to the beneficiary on his twenty-first birthday unless he, at that time, elects to have the trust continue. § 2503; Treas. Reg. § 25.2503-4(c) (1958); Rev. Rul. 218, 1960-1 CUM. BULL. 378; Struthers v. Kelem, 218 F.2d 810 (8th Cir. 1955); Bernie Clinard, 40 T.C. 878 (1963); Bonnie Heath, 34 T.C. 587 (1960); Peirsol, *Gifts to Minors: How Effectively has the Uniform Act Functioned?*, N.Y.U. 25TH INST. ON FED. TAX —, — (1967); Frazier, *Recent Developments in Trusts for Minors*, N.Y.U. 21ST INST. ON FED. TAX 299, 300 (1963). Cf. Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962). In the last cited case the grantor provided that all income would be required to be paid out when the beneficiary reached twenty-one but he would not receive the corpus until he was thirty. The court held that the trust may be split into two parts — income and corpus. The income account was considered a present interest and qualified as a gift by the grantor. The Commissioner, however, has indicated that he will not accept this holding. 1962-1 CUM. BULL. 5.

taxed on their distributive shares of the corporation's profits when earned, not when distributed.<sup>120</sup> Retained earnings, however, may not be paid out (on a tax free basis) to any person not a shareholder during the year in which they were earned. And a shareholder may not sell his shares and then draw out the funds.<sup>121</sup> Similarly, he may not transfer undistributed dividends, for these are considered personal to him and may not be drawn upon by another.<sup>122</sup> Moreover, if he sells all his shares and then repurchases shares, he loses, but then regains the right to receive tax-free distribution.<sup>123</sup> Nor are these requirements unreasonable; for any other provision would allow "treasure hunters" to accumulate treasure at low bracket rates and then to sell out to "high bracket" individuals, who would draw out the profits of the venture.

### B. Operating Losses

The real benefit to a "wildcatting" venture derives from the way in which Subchapter S losses are treated. Operating losses are passed directly on to the shareholders, where they may be deducted from the current year's personal income.<sup>124</sup> If such loss exceeds the shareholder's current taxable income, he may carry it back or forward,<sup>125</sup> in the same manner as any other loss — the only limit being the shareholder's adjusted basis plus any indebtedness the corporation may have to him.<sup>126</sup> However, losses are treated some what differently from earnings. Each is personal and may not be transferred; but losses are calculated on a day-to-day basis,<sup>127</sup> while earnings are adjusted at the end of the year. Thus, a shareholder selling loss stock on the thirtieth of December only transfers one day's loss, whereas the sale of profit stock on the thirtieth passes all undistributed earnings for that year. This

120. Compare § 1373(b) with § 702. Because of the similarity of these two sections Subchapter S corporations are often referred to as "corporations taxed like partnerships."

121. Treas. Reg. § 1.1375-4(e) (1959).

122. *Ibid.* Even a decedent's estate may not take out undistributed profits tax-free.

123. *Ibid.* See Mickey & Wallick, *Tax-Saving Plans under Subchapter S Now More Reliable as Result of New Regulations*, 10 J. TAXATION 268, 269-70 (1959).

124. Section 1374(a); *Hulsey v. Campbell*, 64-1 U.S. Tax Cas. ¶ 9144 (N.D. Tex. 1963); *DuPont v. United States*, 234 F. Supp. 681, 684 (D. Del. 1964), limits the applicability of Subchapter S losses to corporations that carry on a trade or business. It cannot be used to pass hobby losses on to shareholders.

125. Section 172(b); see Treas. Reg. § 1.704-1(d) examples 2 & 3 (1956).

126. Sections 1374(c)(2), 1376(b); *William H. Perry*, 47 T.C. 159 (1966); *John E. Byrne*, 45 T.C. 151 (1965), *aff'd*, 361 F.2d 939 (7th Cir. 1966); *cf. Herbert Levy*, 46 T.C. 531 (1966), requiring that the shareholders, in order to deduct the corporation's operating loss in its final year of operation, be able to show that their stock had some basis at the close of the corporation's final year. The concept of limiting losses to adjusted basis plus debt was introduced as § 704(d) of the partnership provisions during the 1954 re-write. It seems to only appear in Subchapters K and S.

127. Section 1374(c).



difference in treatment reflects the Treasury's policy of preventing "high bracket" taxpayers from capitalizing on the pass-through provisions of the act, since taxing losses on a daily basis eliminates any advantage attendant on purchasing the loss stock. Otherwise the stock, with its built-in operating loss, could be sold to a "high bracket" taxpayer in December and he in turn could resell to a third party in January. Parenthetically, it might be noted that preventing the passage of accumulated earnings is not a problem, for the "high bracket" man attempts to do everything possible to *avoid* taking earnings into his gross income, and a purchase of stock in December could only add to his income, perhaps without even netting him a dividend.<sup>128</sup>

Before a loss will be allowed, the taxpayer must show that it was incurred in the operation of his "trade or business." Normally, this presents no difficulty. However, losses from exploration or development operations are peculiarly subject to attack as "hobby losses." That is, it may be alleged that the taxpayer is not operating a business but is merely pursuing a hobby (which he hopes the government will indirectly subsidize). These cases are particularly difficult to decide, since the line between an expensive hobby and an unprofitable business may be a thin one indeed. As a result, such cases are usually decided on their own individual facts; but the use of a corporate form — even that of a Subchapter S corporation, and especially if endowed with substantial capital — adds color to the claim that the taxpayers are operating a business.<sup>129</sup>

To determine whether they are dealing with a hobby or a business, the older decisions looked to the taxpayer's intent or motive. If he honestly believed he was conducting a business and expects to realize a profit, even though the possibility of his doing so is slight, his losses were deductible. Thus, Mrs. Doggett was allowed to deduct the cost of promoting certain religious books, once she convinced the court that she expected to net a 200 per cent profit when the books were sold. Although it was improbable that she would sell many volumes, the possibility was there, and this seemed to be enough.<sup>130</sup>

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128. Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453, 468 (1959).

129. Compare *DuPont v. United States*, *supra* note 124, with *Temple N. Joyce*, 42 T.C. 628 (1964).

130. *Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933); *accord*, *Tatt v. Commissioner*, 166 F.2d 697, 698 (5th Cir. 1948). However this is no guarantee of success for there is a line of cases denying losses when they were incurred to promote the taxpayer's personal, rather than business interests. *John H. Amon*, 7 CCH Tax Ct. Mem. 577 (1948), *aff'd per curiam*, 177 F.2d 513 (2d Cir. 1949) (purchase of a co-operative apartment as a place in which to live not as an investment); *James F. Curtis*, 39 B.T.A. 366 (1939) (purchase of stock of land company as a condition to obtaining membership in a golf club); *cf.* *Albert G. Boesel*, 11 CCH Tax Ct. Mem. 950 (1952).

The courts soon realized that intent (at least in this area) is a most elusive factor, and to cope with the problem certain guidelines were developed. Some courts have looked to the taxpayer's principal business to determine if his unprofitable activity is a hobby. Thus, in *W. Clark Wise*,<sup>131</sup> the taxpayer owned an automobile agency and lost money on a harness racing stable. Similarly, in *Coffey v. Commissioner*,<sup>132</sup> the taxpayer collected his profits from his mining activities and his losses from a small orange grove where he lived; operation of the grove was held to be a hobby. In *Hirsch v. Commissioner*,<sup>133</sup> taxpayer owned a cannery and lost money on a racetrack.<sup>134</sup> Other courts, in what seems today to be the prevailing test, consider the magnitude of the loss and the length of time over which it has been suffered as one such guideline. Typical is *White v. Commissioner*,<sup>135</sup> where the taxpayer operated a ballistics lab which, in the seventeen years of its existence, lost substantial sums each year. The court pointed out that in addition to the considerable losses over a prolonged period, "there was no evidence of any reasonable possibility of the laboratory's ever generating gross income sufficient to offset its expenses."<sup>136</sup> *DuPont v. United States*,<sup>137</sup> a recent and well-reasoned case, rejected all of these tests.<sup>138</sup> Instead, the *DuPont* court applied a substantive standard, taking into account all of the factors connected with the taxpayer's operations.<sup>139</sup> After considerable discussion, the court seemed influenced most by two of these factors: (1) the taxpayer would eventually realize a profit if he could develop his cattle herd, and (2) in contrast to other gentlemen farmers,<sup>140</sup> he had no other occupation.

Consequently, smaller operations, especially if conducted on a seasonal basis, may have difficulty meeting the regular occupation test.

131. 16 CCH Tax Ct. Mem. 361 (1957), *aff'd*, 260 F.2d 354 (6th Cir. 1958).

132. 141 F.2d 204 (5th Cir. 1944); *cf.* Alfred M. Cox, 24 CCH Tax Ct. Mem. 23 (1965), *aff'd per curiam*, 354 F.2d 659 (3d Cir. 1966).

133. 315 F.2d 731 (9th Cir. 1963); *cf.* Commissioner v. Field, 67 F.2d 876, 877 (2d Cir. 1933).

134. 315 F.2d at 733-34. This case is colored somewhat by the fact that the investment was made in an attempt to prevent a prior investment from going sour.

135. 227 F.2d 779 (6th Cir. 1955), *cert. denied*, 351 U.S. 939 (1956); *but see* Whitney v. Commissioner, 73 F.2d 589, 592 (3d Cir. 1934); Rowe B. Metcalf, 22 Tax Ct. Mem. 1402 (1963).

136. 227 F.2d at 780; Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963); Coffey v. Commissioner, 141 F.2d 204, 205 (5th Cir. 1944); L. M. Lockhart, 43 T.C. 776 (1965); *but see* DuPont v. United States, 234 F. Supp. 681, 685 (D. Del. 1964): "A rule which would require that the profit motive dominate all other considerations before one can carry on a trade or business within the meaning of the federal revenue act is not a realistic test."

137. 234 F. Supp. 681 (D. Del. 1964).

138. *Id.* at 685.

139. *Ibid.*

140. Compare DuPont v. United States, 234 F. Supp. 681 (D. Del. 1964), with Deering v. Blair, 23 F.2d 975 (D.C. Cir. 1928).

The Commissioner may, not unreasonably, assert that the same tax principles are applicable to a gentleman farmer and a part-time treasure hunter. However, one qualification exists: If the firm declares its loss — even though disallowed — and subsequently realizes a profit, it should be allowed to deduct former operating losses from its current profit. And it should be noted that while the courts are directly concerned only with activities occurring in the tax year in question, they will consider and be influenced by operations prior and subsequent to those years. Thus, when Widener's stables realized substantial profits due to stud fees in years following the ones actually in question, the business loss was allowed,<sup>141</sup> though only the year before Vanderbilt had been denied a deduction in a very similar situation.<sup>142</sup> Of course, substantial operations, employing full time personnel and involving a large amount of risk capital, should be treated as any other similar corporate venture would be. Should Sea Treasures earn initial profit and then incur a loss while profits remain undistributed, the loss is set off against the previously taxed undistributed income.<sup>143</sup> And if the election is terminated, undistributed earnings may only be taken out tax-free after all pre-election earnings have been distributed.<sup>144</sup> Clearly, a corporation electing at the outset, rather than after a recovery has been made, need not be concerned with this problem. On the contrary, if its shareholders withdrew their profits as earned, they could not be locked-in and losses generally could be utilized.

One of the principal advantages of the Subchapter S corporation has always been the treatment of capital gains. Section 1375 allows long-term gains from the sale of property not held primarily for sale in the ordinary course of trade or business<sup>145</sup> to be passed through to the shareholders.<sup>146</sup> If we may refer back to our discussion of capital gains it will be recalled that underwater prospecting carried on in the corporate form may put the corporation into the treasure hunting business, and a determination that the corporation is in such a business will deprive its shareholders of capital gains treatment of the proceeds resulting from the sale of any treasure they recover. However, one caveat must be noted: "If the Commissioner has previously

141. *Commissioner v. Widener*, 33 F.2d 833, 837 (3d Cir. 1929); *cf.* *FTC v. Consolidated Foods Corp.*, 380 U.S. 592, 598 (1965) (court looked to post-merger activity to determine illegality of merger); *Thompson v. Commissioner*, 322 F.2d 122, 127-28 (5th Cir. 1963) (court looked to activities occurring prior to tax year in question to determine taxpayer's business).

142. *Deering v. Blair*, 23 F.2d 975 (D.C. Cir. 1928).

143. Section 1375(d)(2)(B).

144. *Treas. Reg. § 1.1375-4(a)-(b)* (1960).

145. Section 1375(a)(1). Section 1221(a)(1) and *Treas. Reg. § 1.1221-1(b)* (1957), further define this provision.

146. Section 1375(a)(1).

ruled, in connection with hobby losses, that the corporation is not engaged in the business of recovering treasure, he may be estopped from now asserting the contrary. In any event, this problem does not concern the mining or producing firm which *sells* its corporate assets realizing capital gain at the corporate level, and, of course, it is principally this type of organization which utilizes the Subchapter S corporate form. Thus, shareholders, by filing a timely election, are allowed to include capital gains in their income in the same manner as if they, not the corporation, held title to the property sold.<sup>147</sup>

A recent amendment<sup>148</sup> added paragraph (e) to section 1375 and alleviated the difficulty inherent in the requirement that gains must be distributed in the year in which received. Previously, if a corporation realized its gains early in the year and later in the same year suffered losses, the capital gains were converted to ordinary income. Moreover, the corporation that waited until its books were closed had difficulty distributing the proceeds before the end of the year, and while closing the books early, or running a trial balance before the year ended was acceptable for small firms, it became increasingly difficult as the firm grew. Paragraph (e) avoids this dilemma by allowing a distribution made within seventy-five days after close of the corporation's taxable year to be treated as if made before the year had ended. The only requirements are that the shareholders, at the close of the year, maintain their positions until the distribution occurs,<sup>149</sup> and that the distribution be pursuant to a board resolution.<sup>150</sup> This resolution must be made in the year of sale, but it need only order that some of the anticipated capital gain be distributed; the balance may be retained for future distribution or may be reinvested.

Often a corporation, similar to Sea Treasures, would find itself holding greatly appreciated capital assets. Rather than selling its property, paying the corporate tax, and distributing the proceeds — taxed in turn as dividends — it would elect, sell, then terminate.<sup>151</sup> The so-called "one-shot election" effectively eliminated one tax. In an

147. Capital gains are subject to the income averaging provisions. § 1302(a)(2); see H.R. REP. No. 749, 88th Cong., 2d Sess. 180 (1963), and Treas. Reg. § 1.1304-5(d) (1966), for an example illustrating the mechanical application of the capital gains rule. See also Goldberg, *Income Averaging under the Revenue Act of 1964*, 74 YALE L.J. 450, 479 (1965). Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1, 4 (1965).

148. 78 Stat. 19, 112, 26 U.S.C. 1371 (1964). See generally S. REP. No. 830, 88th Cong., 2d Sess. 145-46 (1964).

149. Section 1375(e)(2).

150. Section 1375(e)(1).

151. The corporation may easily terminate, even if termination was imminent when the election was made. § 1372(e)(1); Treas. Reg. § 1.1372-4(b)(3) (1960); *Hauptman v. Director of Internal Revenue*, 309 F.2d 62 (2d Cir. 1962), cert. denied, 372 U.S. 909 (1963). See also Patty, *Qualification and Disqualification under Subchapter S*, N.Y.U. 18TH INST. ON FED. TAX 661, 682-83 (1960).

attempt to restrict "one-shot elections" Congress early in 1966 enacted remedial legislation.<sup>152</sup> A new section, 1378, was added to the Code. This section is designed to impose a capital gains tax at the corporate level if an election is undertaken merely to pass capital gain directly to the shareholders. To insure that the bona fide Subchapter S corporation was not taxed, a series of escape clauses were written into the statute. At the outset any corporation filing an election within a month after incorporation,<sup>153</sup> or any corporation having operated under Subchapter S during the three years immediately preceding the sale,<sup>154</sup> is outside section 1378. In addition the corporation must have taxable income, including capital gain, of more than 25,000 dollars,<sup>155</sup> it must have capital gain exceeding 25,000 dollars,<sup>156</sup> and finally, capital gain must be greater than ordinary income.<sup>157</sup> If the Commissioner cannot show that the corporation meets all four tests its entire gain is passed through to the shareholders. Thus, a corporation reporting capital gain of 750,00 dollars and ordinary income of 751,000 dollars, or one with an 800,000 dollars gain offset by a 776,000 dollars operating loss is exempt.<sup>158</sup> Sea Treasures can easily qualify. Election before operations are begun — assuming it has been determined that the venture should in fact operate a Subchapter S corporation — will turn the trick.

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152. H.R. REP. No. 1238, 89th Cong., 2d Sess. 6-8 (1966); S. REP. No. 1007, 89th Cong., 2d Sess. 6-7, 16-19 (1966).

153. Section 1378(c) (2).

154. Section 1378(c) (1).

155. Section 1378(a) (2).

156. Section 1378(a) (1).

157. *Ibid.*

158. For other examples see S. REP. No. 1007, 89th Cong., 2d Sess. 19 (1966).