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Notes and Comments: Federal Income Tax Aspects of Incorporating the Small Business

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NOTES AND COMMENTS

FEDERAL INCOME TAX ASPECTS OF INCORPORATING THE SMALL BUSINESS

The corporate form is often superior to other business structures because of the financial flexibility available to the corporation under the corporate income tax provisions of the Internal Revenue Code. The author reviews these sections of the Code and discusses how they affect the decision of a small business to incorporate.

INTRODUCTION

The businessman contemplating a new enterprise should heed the advice of experts who warn, "when in doubt, don't incorporate." Hasty, ill-advised incorporation may be disastrous since the corporation is expensive to form and has serious income tax disadvantages as well. A simplified business form such as a proprietorship or partnership is generally more advantageous to the new, small business. A brief look at these forms will reveal both their usefulness and their limitations.

In a sole proprietorship, there is no separation of the business and the individual owner. All income or loss, regardless of source, is reported on Schedule C of the Internal Revenue Code Form 1040.[1] The sole proprietor is personally liable for all claims against his business.

The general partnership typically involves "two or more persons engaged in a business for profit."[2] Organization is informal and generally inexpensive. The partnership also is not a separate entity for income tax purposes and partners must pay tax on their share of income which is divided equally or as agreed.[3] All partners share in management as well as liability for breach of contract or tort.[4] Acquisition of capital is limited to loans made by the partners to the partnership, loans made by banks to the partnership, and contributions to capital by the partners.

A limited partnership offers the opportunity for a freely transferable investment on which liability is incurred only to the extent of one's contribution. Strict compliance with the Uniform Limited Partnership Act[5] is required and, therefore, entails increased expense. Filing of the manda-

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1. INT. REV. CODE OF 1954, § 61; Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 1.01[1][a] (1974) [hereinafter cited as CAVITCH].
2. MD. ANN. CODE art. 73A, § 6 (1970).
3. *Id.* § 18.
4. *Id.* §§ 15, 18(e).
5. *See* MD. ANN. CODE art. 73 (1970).

tory certificate of disclosure for the benefit of creditors invades the privacy of the limited partner to a greater degree than the incorporator of a corporation. Despite this disclosure and an exposure to liability, the limited partner lacks a voice in the management of the firm.

The simplicity of these business organizations which makes them so useful in the early stages also makes them financially confining for their owners as the business develops in complexity and size. When this happens, the corporation may emerge as the desired form. No transformation should be made, however, without a thorough analysis of the advantages and disadvantages of a corporation compared to a proprietorship and partnership. Special emphasis should be given to the federal income tax aspects in this comparison.

In contrast to simple organizations, a corporation is a separate legal and taxable entity with separate management and ownership, and has the ability to acquire significant amounts of capital. The latter is true not only because large amounts of money can be borrowed, but also because stock can be sold. The notion of insulation from personal liability[6] also initially attracts the layman to the corporate form, but limited liability may be an illusion in the case of a newly formed corporation, for example, where banks and landlords often require a personal guarantee from the owners for corporate loans and leases.[7] Conversely, the same protection as corporate limited liability may be obtained through the use of effective insurance coverage in order to limit personal tort liability without resort to the corporate form.

The real advantage of limited liability lies in the reliance of trade and other creditors on the corporation.[8] Furthermore, limited liability is not absolute; fraud perpetrated by the stockholders provides an impetus for piercing the corporate veil and holding the stockholders liable. This principle has special import for the small or one man corporation because in Maryland no minimum capitalization is required of a corporation.[9] Consequently, less than reasonable capitalization for the type of business being carried on may constitute a fraud on creditors.[10]

The corporation also has the advantages of perpetual existence,[11] free transferability of ownership, and many statutory powers.[12] Since a general

6. Limited liability means that a shareholder is liable only to the extent of capital contributed to the corporation; personal assets cannot be reached.
7. CAVITCH § 1.01 [2] [a]; W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY-HELD CORPORATIONS § 1.4 (1971) [hereinafter cited as PAINTER].
8. CAVITCH § 1.01[2][a] points out the mortgage situation: "Where the lender feels adequately secured by the mortgage it may not ask for personal guarantees of the stockholders."
9. *See* Obre v. Alban Tractor Co., 228 Md. 291, 197 A.2d 861 (1962) where capital in a venture was held not to be unreasonable; therefore, a note to the corporation by the sole shareholder was not a capital investment. No fraud was alleged. Note that Maryland requires no minimum capitalization. *See* MD. ANN. CODE art. 23 (1973).
10. 228 Md. at 294, 179 A.2d at 862.
11. The death of the proprietor or any partner (absent agreement to the contrary) terminates the business arrangement.
12. See INDEX CCH 1975 STAND. FED. TAX REP. ¶ 240.09 for a complete outline of the non-tax and tax comparison of partnership and corporation. J. SOBELOFF, TAX AND BUSINESS ORGANIZATION ASPECTS OF SMALL BUSINESS ch. 2 (4th ed. 1974) [hereinafter cited as SOBELOFF] gives an in-depth discussion.

partnership, at least, can accomodate such factors as continuity of existence and centralized management, tax considerations become the most important reason for incorporation.

Some major areas of corporate tax which should be considered by the prospective incorporator include tax-free transfers to a controlled corporation,[13] taxable transfers,[14] and Subchapter S status[15] (an alternative to the normal method of taxing corporations). Selection of a taxable year,[16] selection of a method of accounting,[17] amortization of organizational expenses,[18] and other tax elections also merit analysis.

The structure of a corporation results in a different method of taxation from a partnership or a proprietorship. Because the corporation is a separate legal entity for tax purposes, its earnings are fully taxed to it. If after-tax profits are then distributed in the form of dividends, they are taxed as ordinary income to the shareholders.[19] When the shareholders are also principal owners of the corporation, the result is double taxation. Taxable income of the corporation in the shareholder-owner situation can be minimized by the deduction of reasonable salaries paid to the shareholders,[20] rental payments to shareholders who lease assets to the corporation,[21]

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13. INT. REV. CODE OF 1954, § 351.
14. This involves the intentional avoidance of Section 351 which is not an elective provision of the Internal Revenue Code. See discussion at p. 384 *infra*.
15. INT. REV. CODE OF 1954, §§ 1371–77. Subchapter S status may be elected by a small business organization if it meets the statutory requirements. See discussion at p. 369 *infra*.
16. INT. REV. CODE OF 1954, § 441(b) defines taxable year as:
    (1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;
    (2) the calendar year if subsection (g) [which considers the taxpayer who keeps no books] applies;
    (3) the period for which the return is made, if a return is made for a period of less than 12 months.
    Id. § 441(c) defines annual accounting period as the "annual period on the basis of which the taxpayer regularly computes his income in keeping his books."
    Id. § 441(e) defines fiscal year as "a period of 12 months ending on the last day of any month other than December."
    Id. § 446; Treas. Reg. § 1.446-1(c)(1)(i)&(ii) (1958) defines the traditional methods of accounting as follows:
    > [U]nder the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income . . . are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made.
    > [U]nder an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy . . . INDEX CCH 1975 STAND. FED. TAX REP. ¶ 237.02 gives a comparison of these two methods.
18. INT. REV. CODE OF 1954, § 248.
19. *Id.* § 116(a). Only the first $100 ($200 if married and filing joint returns) is excludible. The corporation does not have to distribute income, but risks the application of the accumulated earnings tax if it accumulates over $100,000. See discussion at p. 368 *infra*.
20. INT. REV. CODE OF 1954, § 162. The status of reasonable salaries in close corporations has been the subject of much litigation because, as one commentator has warned:
    > [S]alaries to controlling shareholder-employees are deductible as an expense to the corporation only if they are reasonable in amount for services actually rendered. "Reasonable" is a slippery term and gives the tax gatherer a great leeway

"interest payments on loans made by shareholders to their corporation,"[22] and other business expenses.[23] Even though the shareholder in a corporation who is also an employee of that corporation will be taxed on his salary and dividends as ordinary income,[24] income retained by the corporation for legitimate business purposes is not doubly taxed and distribution in the form of dividends may be deferred to later years. On the other hand, in a partnership all income passes through to the partners and is taxed annually, providing less flexibility for long-range planning.[25] Of course, a partner may lend money back to the partnership on a planned basis, but he cannot defer taxation of his distributable share of the partnership's profits.

FRINGE BENEFITS

The Internal Revenue Code (the "Code") provides special advantages to the owners of a small business operated in the form of a corporation, advantages which are available only to a limited extent in other types of organizations which are not corporate in form. One of these is the extensive employee-benefit plans which also benefit the employer-corporation in its tax ramifications. A corporation may create a qualified pension or profit-sharing trust which does not discriminate in favor of officers, shareholders, or highly compensated employees.[26] Contributions made by the corporation to the trust for such a plan will be a tax deductible business expense and all income produced by the trust will be exempt from taxation.[27] The

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in disallowing the deduction when salaries are in excess of those paid by comparable enterprises. . . .

SOBELOFF 76–77. *See, e.g.*, Builders Steel Co. v. Commissioner, 197 F.2d 263 (8th Cir. 1952) (test for reasonable salaries in closely held corporation); Lewis Food Co. v. United States, 193 F. Supp. 611 (S.D. Cal. 1961); McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970) (despite finding of reasonable salaries, a portion was considered as a distribution since no dividend had ever been declared); Griffin & Co. v. United States, 389 F.2d 802 (Ct. Cl. 1968); Akten Realty Corp., 19 CCH TAX CT. MEM. 150 (1960).

21. By leasing assets, the shareholder, as well as the corporation, can benefit by taking valuable depreciation deductions.
22. PAINTER § 1.3; INT. REV. CODE OF 1954, § 162. Interest payments may raise the spector of thin incorporation unless the debt created is bona fide. *See, e.g.*, Covey Inv. Co. v. United States, 377 F.2d 403 (10th Cir. 1967) (notes found to be corporate shares; interest non-deductible); Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967); Perma-Rock Prod. Inc. v. United States, 373 F. Supp. 159 (D. Md. 1973); Metropolitan Inv. Co. v. United States, 72-2 CCH U.S. Tax Cas. 85,914 (D. Ohio 1972); *see* INT. REV. CODE OF 1954, § 385, which provides rules for distinguishing debt from stock interests.
23. INT. REV. CODE OF 1954, § 162.
24. *Id.* § 16. Section 116 requires the inclusion of stock dividends. See note 19 *supra*. This dividend may have resulted from the sale of a capital asset by the corporation. In a general partnership, the income would pass through to the partners with favorable capital gains treatment. INT. REV. CODE OF 1954, § 702(a), (b).
25. PAINTER § 1.3.
26. INT. REV. CODE OF 1954, § 401. The qualifications on the trust are numerous and include parts of §§ 404 and 410.
27. This is really deferred income as far as the employee is concerned since he will pay taxes on the employer's contribution when he finally receives it. Rev. Rul. 62-139, 1962-2 CUM. BULL. 123 requires a deduction under § 404 to meet the requirements of an ordinary and necessary business expense and reasonable compensation under § 162(a).

corporation is limited in the amount it can contribute,[28] but the self-employed individual who contributes to an employee plan is more severely limited to the lesser of $7,500 or 15 percent of the "earned income derived by such employee from the trade or business with respect to which the plan is established."[29] For example, if earned income amounts to $20,000, only $3,000 may be deducted since 15 percent is the lesser of the two amounts. If 15 percent of the earned income is more than $7,500, only $7,500 may be deducted.[30]

The beneficial result to the corporation which has employee-benefit plans is three-fold. First, taxable corporate income is reduced. Second, the shareholder who is also an employee of the corporation accumulates larger amounts of money for his personal pension than would be permissable in a partnership or sole proprietorship. Third, tax is deferred on the investment income of the trust thus leaving more money available for reinvestment.

An additional advantage of operating as a corporation is the benefits of employee health plans. Exclusion from gross income of amounts received under an accident or health plan by an employee[31] are denied to a self-employed individual[32] even though he is considered an employee for Section 401[33] purposes. Thus, a small corporation can finance a health care plan for its employees who are also owners; deduct contributions as a business expense,[34] and reduce taxable earnings. A sole proprietor must bear the cost of his health insurance and the business will receive no corresponding deduction although he may deduct contributions to an accident or health plan for other employees.[35]

DISADVANTAGES

The advantages of incorporation must be weighed against the disadvantages in order to make an informed decision. Many provisions of the Code

28. INT. REV. CODE OF 1954, §§ 404(a)(3)-(7).
29. *Id.* § 404(e)(1). In § 401(c), the Code gives definitions of self-employed individuals and owner employees:
    (1) Employee—"An individual who has earned income . . . ."
    (2) Earned income—"net earnings from self-employment . . . ."
    (3) Owner-employee—"employee who
    (A) owns the entire interest in an unincorporated trade or business or
    (B) in the case of a partnership, is a partner who owns more than 10 per cent of either the capital interest or the profits interest in such partnership.
    To the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence."
    (4) Employer—"An individual who owns the entire interest in an unincorporated trade or business . . . . A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (1)."
30. 3 CCH 1975 STAND. FED. TAX REP. ¶ 2658E.04.
31. INT. REV. CODE OF 1954, § 105(b) does not require the taxpayers to include reimbursed medical expenses while § 105(c) excludes payments for permanent handicaps.
32. INT. REV. CODE OF 1954, § 105(g).
33. *Id.* § 401(c)(1).
34. *Id.* § 162; Treas. Reg. § 1.162-10(a) (1958).
35. INT. REV. CODE OF 1954, § 106.

can be traps for the small corporation. A penalty tax (i.e., in addition to regular corporate income tax) of 27½ percent of accumulated taxable income under $100,000 and 38½ percent of accumulated taxable income over $100,000 is imposed on corporations,[36] primarily to discourage tax avoidance on corporate earnings by retaining them in the corporation. This penalty may be avoided by not permitting earnings and profits of a corporation to accumulate beyond the reasonable needs of the business.[37] Another pitfall is the possibility of personal holding company status[38] thus incurring a tax of 70 percent of undistributed income.[39] This provision is particularly dangerous for the one-man professional corporation where income is solely derived from personal service contracts.[40] This tax also discourages tax avoidance by a failure to distribute income; therefore, yearly distribution of earnings, even by a corporation which qualifies for personal holding company status, avoids the tax.

Treatment of net operating losses is more advantageous to a proprietorship or partnership than to a corporation. Owners of unincorporated businesses can recognize ordinary net operating losses on their individual tax returns, but shareholders in a corporation are denied recognition of corporate losses until liquidation of the corporation or sale of their stock.[41] This denial is mitigated by Section 1244, however, which allows the owner of stock in a small business corporation to deduct the loss as an ordinary rather than a capital loss.[42] This provision successfully overcomes cases like *Whipple v. Commissioner*[43] where an individual was not permitted to deduct as worthless debts, loans made to his wholly owned corporation. The loans were held to be non-business bad debts. Issuance of Section 1244 stock now guarantees an ordinary[44] loss deduction to the shareholder in case of worthlessness of the stock. The shareholder must come within the limits of Section 1244 in order to take advantage of the loss.[45]

Another disadvantage of the corporate form is the second-user concept of depreciable property transferred to the corporation. A corporation as well as

36. *Id.* §§ 531-37; *See* CAVITCH §§ 2.01-.02.
37. INT. REV. CODE OF 1954, § 533(a).
38. A personal holding company is defined by INT. REV. CODE OF 1954, §§ 542-43 as any corporation where at least 60 per cent of its adjusted ordinary gross income is income from dividends, interest, royalties, and annuities, personal service contracts, and estates and trusts.
39. INT. REV. CODE OF 1954, § 541.
40. *See* Rev. Rul. 72-372, 1971-2 CUM. BULL. 241; Rev. Rul. 59-172, 1959-1 CUM. BULL. 144.
41. INT. REV. CODE OF 1954, § 1211.
42. *Id.* § 1221 defines capital asset as any property held by the taxpayer, business or personal and lists specific exclusions to that definition. When such an asset is sold, the gain is taxed at the favorable rates (i.e., 50 percent of normal rates). *See id.* § 1202. Capital loss treatment is not considered favorable since it is severely limited. For example, a corporation may deduct losses only to the extent of gains. *Id.* § 1211.
43. 373 U.S. 193 (1963).
44. "An ordinary loss is a loss from the sale or exchange of an asset which is not a capital asset." Treas. Reg. § 1.1244-1(a)(1) (1961).
45. INT. REV. CODE OF 1954, § 1244(a) states that the shareholder must be an individual or partnership and cannot be a trust or an estate. Section 1244(b) states that a maximum of $25,000 (or $50,000 if married and filing a joint return) may be treated as a loss. *See generally* § 1244 for further requirements.

an unincorporated business is normally entitled to a deduction for "exhaustion, wear and tear...of property used in the trade or business."[46] When, however, property which has been depreciated by one of the accelerated methods of depreciation[47] is transferred to a corporation, the corporation is not the original user of the property. Consequently, the corporation is limited to the straight-line method of depreciation.[48]

All of the foregoing factors must be carefully considered before the decision to incorporate is made. A cursory judgment that high business earnings coupled with high personal income automatically indicates incorporation should not be made. Other methods may be available to alleviate the unfavorable tax situation which places the taxpayer in a higher individual tax bracket than the corporate tax. As one commentator warns: "The only reliable way in which a conclusion can be drawn as to whether a corporation betters or worsens the business owner's tax situation is by making trial computations based upon assumed projected future income."[49] Special attention should be given to the possibility of incurring the personal holding company and accumulated earnings penalty taxes.[50] Subsequent to these considerations and projections, a knowledgeable decision to incorporate may follow.

SUBCHAPTER S STATUS

For the small businessman contemplating incorporation, Subchapter S status[51] should be considered. Subchapter S was designed to benefit the small businessman operating in corporate form. It provides an alternate form of corporate taxation. If loss during the early years of operation is anticipated and the protection of limited liability which corporate status confers is desired, Subchapter S may be tailor-made. The statutory scheme has been compared to the tax treatment of a partnership; however, this can be a dangerous analogy for there are material differences between the two. Significantly, a Subchapter S corporation is subject to the corporate tax provisions concerning "corporate redemption, liquidations, reorganizations, and many other transactions."[52] Termination of the elective status results in the application of normal corporate taxation,[53] not partnership taxation.

In order to qualify for Subchapter S treatment, an organization must

46. INT. REV. CODE OF 1954, § 167(a)(1).
47. *Id.* § 167(b) (2), (3). The two accelerated methods are the declining balance method and the sum of the years digits method.
48. INT. REV. CODE OF 1954, § 167(c); Rev. Rul. 56-256, 1956-1 CUM. BULL. 129.
49. CAVITCH § 1.01[1][b]. The author gives a thorough explanation of these computations.
50. See discussion at p. 368 *supra*.
51. INT. REV. CODE OF 1954, §§ 1371-79. The Code terminology is tax-option corporation. For a detailed analysis of the various aspects of Subchapter S, *see generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 6.01-11 (1971) [hereinafter cited as BITTKER & EUSTICE]; CAVITCH §§ 3.01-.08; I. GRANT, SUBCHAPTER S TAXATION (1974); D. KAHN, BASIC CORPORATE TAXATION 379-413 (1973); PAINTER § 1.10.
52. BITTKER & EUSTICE ¶ 6.01.
53. INT. REV. CODE OF 1954, § 1372.

meet the Code's requirement of a "small business corporation." "The term 'small business corporation' means a domestic corporation which is not a member of an affiliated group[54] and which does not (1) have more than 10 shareholders; (2) have as a shareholder a person...who is not an individual;[55] (3) have a non-resident alien as a shareholder; and (4) have more than one class of stock."[56] When the corporation has met these prerequisites, the shareholders may elect Subchapter S status. Revenue Ruling 72-257 defines the period in which the election may be made as "the date Articles of Incorporation are filed begins the one-month period for filing a small business corporation's election under Section 1372(c) of the Code, where State law provides that the corporate existence begins and stock subscribers become 'shareholders' on the day the Articles are filed."[57] This filing is the process by which a corporation comes into existence in Maryland.[58] Importantly, unanimous consent of the shareholders is required for the election to be effective.

The advantage of Subchapter S exists in taxation of corporate earnings at each shareholder's personal tax bracket which, in normal situations, is substantially lower than corporate rates. Both distributed income in the form of dividends, and undistributed income (i.e., earnings retained by the corporation) is taxed as ordinary income.[59] This constructive dividend[60]

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54. *Id.* § 1504 gives the definition of Affiliated Group as:
> [O]ne or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if
>
> (1) [s]tock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and
>
> (2) [t]he common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.
>
> As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.
>
> (b) DEFINITION OF "INCLUDIBLE CORPORATION".—As used in this chapter, the term "includible corporation" means any corporation except—
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> (1) [c]orporations exempt from taxation under section 501.
>
> (2) [i]nsurance companies subject to taxation under section 802 or 821.
>
> (3) [f]oreign corporations.
>
> (4) [c]orporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.
>
> (5) [c]orporations organized under the China Trade Act, 1922.
>
> (6) [r]egulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.
>
> (7) [a] DISC or former DISC....

55. *See* Fulk & Needham, Inc. v. United States, 411 F.2d 1403 (4th Cir. 1969). In this case a trust which was created by a will became a member of a Subchapter S corporation. The court held that a trust was not an individual within the meaning of Section 1371.
56. INT. REV. CODE OF 1954, § 1371.
57. 1972-1 CUM. BULL. 270.
58. MD. ANN. CODE art. 23, § 131(b) (1973).
59. INT. REV. CODE OF 1954, § 1373.
60. BITTKER & EUSTICE ¶ 6.05. Although the term itself is not used in the Code, Treas. Reg. § 1.1373-1(e) (1959) speaks of "[d]ividend resulting from constructive distribution of undistributed taxable income."

increases the basis[61] of the shareholders' stock *pro tanto*.[62] "In effect, the 'constructive dividend' is treated as though it had been distributed to him and then reinvested in the form of a contribution to capital."[63]

One exception to the ordinary treatment of income is the passing through of capital gains from the corporation to the shareholders. With certain qualifications, the shareholders may treat their proportionate share as capital gain if there is an excess of long-term capital gain over net short-term capital loss.[64]

Finally, and most significantly for the small corporation, corporate net operating loss is passed through to provide an ordinary deduction to the shareholders.[65] It is limited, however, to the extent of the adjusted basis of the shareholders' investment in the corporation.[66] Thus, Subchapter S provides the opportunity to be taxed at ordinary rates, to take advantage of losses, and to limit liability by the use of the corporate form.

While Subchapter S benefits are favorable, the complexity of its provisions can ensnare the uninitiated practitioner. The major area which has caused problems is involuntary termination of Subchapter S status, the adverse effects of which are compounded because termination is automatic and, therefore, can occur without the knowledge of the shareholders.[67] Automatic termination can occur when the corporation ceases to be a small business organization.[68] "For example: the corporation forms a subsidiary; an eleventh individual acquires stock; a trust, a corporation, or partnership acquires stock; a non-resident alien acquires stock; or a second class of stock is issued to existing shareholders."[69]

Subchapter S status may also be terminated when more than 80 percent of gross receipts stem from sources outside the United States[70] or where more than 20 percent of gross receipts are derived from passive investment income.[71] Passive investment income is defined by the Code as "gross

61. See note 120 *infra* for definition.
62. INT. REV. CODE OF 1954, § 1376(a). *See also* Johnson, *Disproportionate Taxation Under Subchapter S*, 2 TAX ADVISOR 528 (1971).
63. BITTKER & EUSTICE ¶ 6.05.
64. INT. REV. CODE OF 1954, § 1375 which states the qualifications; *see* BITTKER & EUSTICE ¶ 6.06; see note 42 *supra*.
65. INT. REV. CODE OF 1954, § 1374.
66. *Id.* § 1374(c)(2). *See generally* Carter, *Selective Election of Subchapter S Status for Net Operating Loss Pass-Through*, 27 TAX LAW. 465 (1974); BITTKER & EUSTICE ¶ 6.10 add some other uses for Subchapter S:

> While elimination of the corporate tax is the main concern of Subchapter S, several other important uses of the election have been noted: (a) the pass-through of current corporate net operating losses, especially in the early years of a new business . . . ; (b) one-shot elections for the purpose of passing through nonrecurring capital gains from the sale of corporate property . . . ; (c) avoiding the collapsible corporation provisions . . . ; and (d) obtaining the benefits of Sec. 453 deferral where corporate assets are sold on the installment method.

67. INT. REV. CODE OF 1954, § 1372(e).
68. *Id.* § 1372(e)(3).
69. Vogel, *Termination of Subchapter S Status: When Does It Happen and What Happens When It Does*, 1 J. CORP. TAX. 9 (1974). This article presents a lengthy treatment of involuntary termination.
70. INT. REV. CODE OF 1954, § 1372(e)(4).
71. *Id.* § 1372(e)(5).

receipts derived from royalities, rents, dividends, interest, annuities, and sales or exchanges of stock or securities."[72] The interpretation of this definition has been litigated repeatedly. In the recent case of *Zychinski v. Commissioner*,[73] the Eighth Circuit Court of Appeals affirmed the Tax Court's holding on the issue of passive investment income. The petitioners formed a corporation in 1964 and in 1966 elected Subchapter S status. The main activity of the petitioner's corporation was "purchase and sales of stocks or securities for its own account."[74] Net operating losses in 1966 were passed through in accordance with Subchapter S. The petitioners argued that since their business was "active," gain from the sale was not passive.[75] The Eighth Circuit stated: "The difficulty with [the] taxpayers' position, as the Commissioner points out, is that they are 'attempting to define colloquially a term which is already defined statutorily.'"[76] The result was that Subchapter S status terminated for the years in question. There was small comfort in the fact that the corporation, "during the years ending October 31, 1966 and 1967, *considered* itself still to be a valid Subchapter S corporation."[77] Strict adherence to the requirements of Subchapter S is the caveat of this case.

The meaning of "one class of stock" is another definition which causes termination of Subchapter S status, if interpreted incorrectly, because of restrictive regulations and rulings from the Internal Revenue Service (the "Service"). In fact, the definition of one class of stock has been so severely hemmed[78] that it "is a significant limitation on the ability of those who form a Subchapter S corporation to engage in intelligent business planning."[79] Fear of losing Subchapter S status may inhibit stockholders from making loans to the corporation because the loans may be viewed as stock by the Service.[80] This restricts flexibility in creating needed cash-flow by withdrawal of debt principal when needed. Two classes of stock are permissible when the only reason for the classes is allocation of voting for directors.[81] A recent case, *Parker Oil Co.*,[82] shows a change in the attitude of the Service. In that case, the Tax Court held that an irrevocable proxy arrangement did not create a second class of stock. The Service acquiesced in the decision and issued Revenue Ruling 73-611 to clarify the situation.[83] This case and ruling, as well as other judicial decisions favorable

72. *Id.* § 1372(e)(5)(C).
73. 506 F.2d 637 (8th Cir. 1974).
74. 60 T.C. 950, 952 (1973).
75. 506 F.2d at 638.
76. *Id.*
77. 60 T.C. at 951 (emphasis added).
78. Treas. Reg. § 1.1371-1(g) (1959); Rev. Rul. 73-611, 1963-2 CUM. BULL. 312.
79. PAINTER § 1.10. *See also* Catalina Homes Inc., 23 CCH TAX CT. MEM. 1361 (1964); see Kess and Malin, *Recent Developments and Subchapter S*, 170 N.Y. L.J. 1 (1973).
80. Henderson v. United States, 245 F. Supp. 782 (1965). *See generally* Liles, *Re-Classification of Stockholder Debt in Subchapter S Corporation: An Alternative To Finding a Second Class of Stock*, 25 ALA. L. REV. 612 (1973). State law may have the effect of creating a second class of stock. Rev. Rul. 71-522, 1971-2 CUM. BULL. 316.
81. Treas. Reg. § 1.1371-1(g) (1959).
82. 58 T.C. 985 (1972), *acquiesced in*, 1973-2 CUM. BULL. 3.
83. 1973-2 CUM. BULL. 312.

to the taxpayer,[84] will enhance future flexibility of the Subchapter S corporation. Control of the corporation by different classes of stock, however, continues to be impossible.

Once termination occurs, it "affects the taxable year of the corporation in which occur the events causing the termination."[85] Furthermore, it denies re-election "for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective...."[86] As a consequence, regular corporate taxation, an unexpected and heavy burden, ensues for five years affecting both the Subchapter S corporation and its shareholders. These effects of regular taxation can be offset by depleting taxable income by the use of reasonable salaries to officers and directors and other legitimate deductions.[87] Loss of Subchapter S status also imperils undistributed income which had been taxed under Subchapter S provisions. Presently, it may not be distributed to the shareholders without additional tax.[88]

In addition to involuntary termination, certain provisions of Subchapter S have other adverse consequences to the stockholders. Transfer of stock, for instance, is unfavorable to the transferee when previously taxed income is undistributed. The transferor-shareholder may receive this income[89] later as tax-free income as long as he retains any of the stock, but this right does not inure to the transferee of such stock.[90] Consequently, the transferee incurs a tax liability on the transferred stock which, of course, lessens its value to him. Distribution prior to transfer of the stock will avoid this tax burden on the transferee if such distribution is possible.[91]

Secondly, previously taxed income which is undistributed in one year may be reduced by a corresponding net operating loss in the next year pursuant to Section 1375(d).[92] This is because the stockholder has received the benefit of the net operating loss by the pass through provisions.[93] This

84. *See, e.g.*, Portage Plastics Inc. v. United States, 486 F.2d 632 (7th Cir. 1973). In that case, the Seventh Circuit Court of Appeals held that traditional methods of classifying debt as equity for thin corporation purposes was not a proper test for finding a second class of stock under Subchapter S provisions. Pending amendments to Treas. Reg. § 1.1371-1(g) (1959), the Service will not litigate the issue. T.I.R. 1248 (1973).
85. INT. REV. CODE OF 1954, § 1372(e)(2); Treas. Reg. § 1.1372-4(c) (1959).
86. INT. REV. CODE OF 1954 § 1372(f); Treas. Reg. § 1.1372-5 (1959). The corporation may re-elect Subchapter S status if the Commissioner consents; however, Treas. Reg. § 1.1372-5 (1959) states that the burden is on the corporation to establish the facts which would cause such consent. Termination must have been beyond the corporation's control and not part of a planned termination.
87. See note 20 *supra*.
88. Treas. Reg. § 1.1375-4(a) (1961). The pertinent sentence states: "If an election is terminated under Sec. 1372(e), the corporation may not during the first taxable year to which the termination applies or during any subsequent taxable year, distribute previously taxed income of taxable years prior to the termination as a non-dividend distribution ...."
89. INT. REV. CODE OF 1954, § 1375(d); Treas. Reg. § 1.1375-4 (1961).
90. Treas. Reg. § 1.1375-4(e) (1961) states: "A shareholder's right to non-dividend distributions under this section is personal and cannot in any manner be transferred to another." *See also* Ghingher, *Shareholders' Agreements For Closely Held Corporations-Special Tools For Special Circumstances*, 4 U. BALT. L. REV. 211 (1975).
91. I. GRANT, SUBCHAPTER S TAXATION § 6.4 (1974).
92. INT. REV. CODE OF 1954, § 1375(d)(2)(B)(i).
93. *Id.* § 1374(b).

may best be illustrated by an example taken from the regulations:

> *Example* (1). (i) Corporation X, of which A (a calendar year taxpayer) is the sole stockholder in an electing small business corporation for its taxable years ending December 31, 1958, 1959 and 1960. For its taxable year 1958 it has a net operating loss of $10,000. For its taxable year 1959 it has undistributed taxable income of $50,000. Assuming that A included in his return the undistributed taxable income for 1959 and assuming that the 1958 net operating loss did not exceed the limitation imposed by section 1274(c) (2), A's share of previously taxed income as of January 1, 1960, is $40,000.
>
> (ii) Assume the additional fact that for the taxable year 1960 Corporation X has a net operating loss of $40,000, which is fully allowable to A as a deduction. This net operating loss does not affect A's share of previously taxed income for purposes of determining the nature of distributions during 1960, since such net share is reduced only by the deductions allowable for taxable years of the shareholder ending before the distribution. However, in computing his net share of previously taxed income for years *subsequent* to 1960, A must take the $40,000 deduction for 1960 into account.[94]

"A distribution after the loss, may, therefore, be taxed as a dividend even though the same amount would have enjoyed the protection of Section 1375(d) had it been distributed earlier."[95] The need for retention of capital in the business coupled with the requirement that these distributions be made in cash[96] negates the possibility of avoiding this situation. Moreover, cash distributions may be difficult for the new, small corporation in a tight cash position. Distribution of cash to stockholders with subsequent return of funds to the corporation as a loan has been suggested as a possible solution.[97] This approach is not completely satisfactory because of the possibility that the debt will be classified as a second class of stock[98] or as a distribution of property. When such problems are present, regular corporate taxation may be the best choice.

TAX-DEFERRED TRANSFERS—SECTION 351

Incorporation of the proprietorship or partnership is encouraged by tax-free transfer available under Section 351. That section states in part:

> (a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immedi-

94. Treas. Reg. § 1.1375-4(g) (1961) (emphasis added).
95. BITTKER & EUSTICE ¶ 6.08.
96. INT. REV. CODE OF 1954, § 1375(d)(2); Treas. Reg. § 1.1375-4(b) (1961).
97. *See* BITTKER & EUSTICE ¶ 6.08.
98. See discussion at p. 372 *supra*.

> ately after the exchange such person or persons are in control ... of the corporation ....

The notion of a totally nontaxable transaction should, however, be qualified. A better designation is "'tax-deferred' because the tax will ultimately have to be paid"[99] (unless death intervenes) when assets are sold, the corporation is liquidated, or stock is sold. Section 351 allows an unincorporated entity to change to the corporate form without the tax consequences of an outright sale where gain or loss would be recognized. Smooth operation of Section 351 has been complicated by confusion over the definition of several terms included in the provision; therefore, a close analysis of these terms will be an aid to the practitioner.

PROPERTY

"Property" in Section 351 includes money,[100] but does not include services. Although Maryland allows services as payment for stock, this provision is limited to stock of a corporation already in existence.[101] Services performed prior to incorporation would not be valid payment in any event. This definition is significant because of the control qualification of Section 351. If an asset is transferred which does not fit the Service's definition of property (for example, a secret formula), the transferor will not be considered to be in control of that portion of the stock transferred for that asset and the transferor may then fall below the 80 percent requirement for control.[102]

CONTROL

The word "control" is defined in the Code as "the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation."[103] The definition does not explicate "immediately after the exchange" which has posed more

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99. O'Bryne & Pennell, *Incorporating the Partnership-Federal Income Tax Considerations*, 17 PRAC. LAW. 54 (1971), in FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 303 (1970) [hereinafter cited as O'BRYNE & PENNELL].
100. *See* Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935). In this leading case the court construed the word property to be a broad inclusive term because "corporations need cash to carry on business." Rev. Rul. 69-357, 1969-1 CUM. BULL. 101 restates the rule concerning money.
101. MD. ANN. CODE art. 23, § 22 (1973) uses the statement "services actually performed for the corporation."
102. *See, e.g.*, Hartman Tobacco Co., 45 B.T.A. 311 (1941), *acquiesced in*, 1942-2 CUM. BULL. 26.
103. INT. REV. CODE OF 1954, § 368(c); *see* Rev. Rul. 69-126, 1969-1 CUM. BULL. 218; Rev. Rul. 59-259, 1954-2 CUM. BULL. 115 which states that the owner "must have 80% of each class of non-voting stock."

difficulty. If the transferor is bound by a legally enforceable obligation prior to the transfer which is also intended to be part of the exchange transaction, there is no control "immediately after the exchange" of more than 80 percent of the stock. *Manhattan Building Co.*[104] reflects this principle. In that case an individual bought assets at a receiver's sale and transferred them to a new corporation pursuant to an agreement with stock underwriters. The stock and bonds were transferred to the individual who, in turn, transferred some stock and all of the bonds to the underwriters. He failed to retain 80 percent of the total stock. The Tax Court, applying the "interdependent transaction" test of an earlier case,[105] found that the individual did not have the requisite control immediately after the exchange.

A complementary line of cases[106] indicates that when no agreement is present, the transferee may subsequently relinquish the transferred stock without losing the tax-free transfer benefits. The existence of a legally enforceable obligation, rather than intent, controls.

> Though it was plainly enough Mr. Chamberlin's intention to create the petitioner and to transfer his property to it for its stock and the assumption of his liability on the two mortgages in order to provide him with stock to give as he did to his relatives, he was under no obligation to make the gift. There is neither claim nor proof that he was bound to carry out his intention to give any of it away when he received the stock or that he was not free at any time up to the very moment he gave it away to change his mind and use it for any lawful purpose. This would, of course, include the use of it to control the petitioner for as long as he desired by virtue of stock ownership far in excess of the 80 per centum....[107]

The donor may form his intent prior to the tax-free transfer, yet retain the benefit of Section 351. In fact, even a sale or transfer will not negate the

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104. 27 T.C. 1032 (1957), *acquiesced in.* 1957-2 CUM. BULL. 5; *see* Ellicott, *Tax and Related Problems of Going Public*, 31 N.Y.U. INST. ON FED. TAX. 675 (1973). Note that:

> It is understood that the Service will rule that a public offering of more than 20 per cent of the transferee's stock in the context of a Sec. 351 exchange will be permitted without breaking control if the underwriting is on a "firm commitment" basis; in a "best efforts" underwriting, the Service requires a representation that the transferors will complete the transaction whether or not the public offering is effected, and that there is no binding commitment of the transferors to sell their stock in the public offering.

BNA TAX MGMT. MEMO 71-14, Tidbit No. 1, at 15 (1971).

105. American Bantam Car Co., 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. den.*, 339 U.S. 920 (1950). The Tax Court stated: "Were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?" 11 T.C. at 405. *See, e.g.*, Hazeltine v. Commissioner, 89 F.2d 513 (3d Cir. 1937); Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936); Rev. Rul. 70-140, 1970-1 CUM. BULL. 73; Rev. Rul. 54-96, 1954-1 CUM. BULL. 111.

106. *See, e.g.*, Wilgard Realty v. Commissioner, 127 F.2d 514 (2d Cir. 1942), *cert. den.*, 317 U.S. 665 (1942).

107. 127 F.2d at 516.

tax-free character of the exchange if no legally enforceable obligation was incurred prior to and as an integrated part of the exchange.[108]

SECURITIES

The definition of "securities" has caused much confusion. "Stock" has been defined elsewhere in the Code,[109] and the regulations give some guidance on what is *not* to be considered stock,[110] but "securities" has been left to the courts for illumination:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purposes of advances, etc.[111]

The cautious attorney will, however, insist on debt instruments with a seven to ten year maturity date to negate other possible inferences.[112]

Finally, a note or debenture which has passed the test must still be accompanied by some stock on the transfer unless "the transferor was already the owner of stock of the transferee corporation at the time of the properties-for-securities exchange."[113] The rationale is that the person will be in control immediately after the exchange because he already owns the requisite percentage of stock. If, however, there are four transferors and three receive stock while one receives solely securities in the form of debt, he will not qualify as a control party under Section 351. His transfer will be a taxable event.[114] It is important that each party to the transaction receive some stock in order to meet the control requirements. These guidelines

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108. *See* American Bantam Car Co. v. United States, 177 F.2d 513 (3d Cir. 1949), *cert. den.*, 337 U.S. 920 (1950) (oral agreement prior to transfer); Rev. Rul. 72-30, 1972-1 CUM. BULL. 287.
109. INT. REV. CODE OF 1954, § 7701(a)(7); *See* Comment, *Sec. 351 Transfers To Controlled Corporations—The Forgotten Terms— "Securities,"* 114 U. PENN. L. REV. 314 (1965).
110. Treas. Reg. § 1.351-1(a)(1) (1955) provides that stock rights or stock warrants are not to be considered as stock or securities in the application of § 351.
111. Camp Wolters Entrp. v. Commissioner, 230 F.2d 555, 560 (5th Cir. 1956), *citing* Camp Wolters Entrp., 22 T.C. 737, 751 (1954). The definition in this case was incorporated into Rev. Rul. 59-98, 1959-1 CUM. BULL. 76.
112. *See, e.g.*, cases where terms of notes were found to be too short to be securities: Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (3½ month promissory notes); Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), *cert. den.* 326 U.S. 726 (1945) (3, 4, and 5 year notes); Wellington Fund Inc., 4 T.C. 185 (1944) (12 month note); *cf.* cases where debt *was* found to be a security: Dennis v. Commissioner, 473 F.2d 274 (5th Cir. 1973) (note had independent significance); Rose Ann Coates Trust, 55 T.C. 501 (1970), *acquiesced in*, 1972-1 CUM. BULL. 1; Mary N. Crofoot, 4 CCH TAX CT. MEM. (1945) (20 year promissory notes).
113. Rev. Rul. 73-473, 1973-2 CUM. BULL. 115. *See generally* Dean, *Transfers To Controlled Corporations: Analyzing The Problem Areas*, 41 J. TAX. 72, 73 (1974).
114. Rev. Rul. 73-472, 1973-2 CUM. BULL. 114.

reflect the general policy of Section 351 which is to aid and encourage tax-free transfers.

BOOT

Section 351 is complicated but not defeated by the receipt of money or other assets in addition to stock or securities. This additional cash or assets is known colloquially as "boot" because stock is received with something extra "to boot." In this situation, gain will be recognized but only to the extent of the cash or the fair market value of the property received.[115] In addition, the gain is taxed only to the individual who receives it.[116] The Service maximizes taxable gain where "boot" is involved by its directive in Revenue Ruling 68-55[117] which requires allocation of the value of the "boot" received to each asset transferred by the stockholder. This method of calculating gain also preserves the spirit of the section by denying loss to the taxpayer on the transfer.

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115. INT. REV. CODE OF 1954, §§ 351(b)(1), and (2) state:

> RECIPT OF PROPERTY—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received, under subsection (a), other property or money, the (1) gain (if any) to such recipient shall be recognized, but not in excess of—
>
> (A) the amount of money received, plus
>
> (B) the fair market value of such other property received; and
>
> (2) no loss to such recipient shall be recognized.

116. INT. REV. CODE OF 1954, § 351(b)(1).

117. 1968-1 CUM. BULL. 140. The ruling states:

> The general rule is that each asset transferred must be considered to have been separately exchanged. . . . [I]t is not proper to total the bases of various assets transferred and to subtract this total from the fair market value of the total consideration received in the exchange. Moreover any treatment other than an asset-by-asset approach would have the effect of allowing losses that are specifically disallowed by section 351(b)(2) of the Code. . . .
>
> Accordingly the amount and character of the gain recognized in the exchange shall be computed as follows:

	Total	A	B	C
Fair Market Value of Asset Transferred	$110×	22×	33×	55×
% of Total Fair Market Value		20%	30%	50%
Fair Market Value of Stock Received	$100×	20×	30×	50×
Cash Received (allocated)	$10×	2×	3×	5×
Amount Realized	$10×	22×	33×	55×
Adjusted Basis	—	40×	20×	25×
Gain (Loss) Realized	—	(18×)	13×	30×

> Under section 351(b)(2) of the Code the loss of 18[000] dollars realized on the exchange of Asset Number I is not recognized. Such loss may not be used to offset the gains realized on the exchanges of the other assets. Under section 351(b)(1) of the Code, the gain of $13[000] dollars realized on the exchange of Asset Number II will be recognized as short-term capital gain in the amount of 3[000] dollars, the amount of cash received. Under sections 351(b)(1) and 1245(b)(3) of the Code, the gain of 30[000] dollars realized on the exchange of Asset Number III will be recognized as ordinary income in the amount of 5[000] dollars, the amount of cash received.

Id. at 141-42.

Section 351 must be applied in connection with other pertinent provisions of the Code. Section 357 states that "other property" under Section 351 will not include liabilities transferred and assumed. It also sets out two important exceptions.[118] First, if the principal purpose for the transfer is tax avoidance, the assumption of the liability will be treated as cash. The absence of a tax avoidance purpose must be substantiated.

> Although the statute itself speaks only of a "bona fide business purpose," the regulations provide that the income tax returns of the transferor and of the corporation for the year of the exchange must state "the corporate business reason" for the assumption of any liability.[119]

The other exception includes liabilities which exceed the total adjusted basis[120] of the property transferred. The excess over the total adjusted basis will be taxable to the extent of the gain.[121] "Thus, if an individual transfers,

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118. INT. REV. CODE OF 1954, § 357 states:

> (a) GENERAL RULE—Except as provided in subsections (b) and (c), if—
>
> (1) the taxpayer receives property which would be permitted to be received under section 351 ... without the recognition of gain if it were the sole consideration, and
>
> (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351. ...
>
> (b) TAX AVOIDANCE PURPOSE—
>
> (1) IN GENERAL—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—
>
> (A) was a purpose to avoid Federal income tax on the exchange, or
>
> (B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351 ... be considered as money received by the taxpayer on the exchange. ...
>
> (c) LIABILITIES IN EXCESS OF BASIS—
>
> (1) IN GENERAL—In the case of an exchange—
>
> (A) to which section 351 applies ...
>
> if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

119. BITTKER & EUSTICE ¶ 3.07.

120. *See* INT. REV. CODE OF 1954. §§ 1011, 1012. INDEX CCH 1975 STAND. FED. TAX REP. ¶ 315 at 8906 states:

> Basis represents what the property cost the taxpayer, actually or constructively, but is of broader meaning than the term "costs." The "basis" (adjusted) of property is deducted from the amount realized to find the gain or loss on its sale. If the taxpayer acquired the property by purchase, the basis is the cost, except in special circumstances ...; After such a basis is determined, it must be adjusted for capital items which increase it, and for deductions taken which decrease it, such as depreciation, depletion, etc.

121. INT. REV. CODE OF 1954, § 357(c).

under Section 351, property having a total basis on his hands of $20,000, one of which has a basis of $10,000 but is subject to a mortgage of $30,000, to a corporation controlled by him, such individual shall be subject to tax with respect to $10,000, the excess of the amount of the liability over the total adjusted basis of all the properties in his hands."[122]

CASH BASIS TAXPAYER AND TRADE ACCOUNTS RECEIVABLE

Section 357 has special significance for the cash-basis[123] taxpayer. This method is usually used by the proprietorship and partnership. In the leading case of *Peter Raich*,[124] the Tax Court held that the petitioner's liabilities exceeded his total adjusted basis in property transferred to the corporation. Raich was a cash-basis taxpayer whose trade accounts receivable were considered to have a zero adjusted basis.[125] His sole proprietorship had $77,361 worth of accounts receivable and $45,992 worth of liabilities at the time of the transfer. The petitioner argued that "Congress did not intend for that provision to apply to a situation, like that in the instant case, where the book value of the assets transferred exceeds the liabilities assumed and where the transferor receives no economic benefit or gain from such assumption."[126] The Tax Court reasoned that if Congress had intended to limit Section 357(c) to book value it would have explicitly done so and charged the taxpayer with the deficiency. The Service reiterated the court's position in Revenue Ruling 69-442[127] which stated that the "trade accounts receivable would not have had a zero basis if the taxpayer had been on the accrual method of accounting prior to the transfer of the business under Section 351."[128] The ruling, therefore, distinguished the basis of trade accounts receivable solely on the method of accounting employed by an unwitting taxpayer. As a consequence, the cash-basis taxpayer faces taxation on his Section 351 transfer if he transfers trade accounts receivable deemed to have a zero basis.

The Second Circuit Court of Appeals attempted to rectify the situation in *Bongiovanni v. Commissioner*.[129] In that case, the taxpayer, a sole proprietor, was cognizant of the unfavorable consequences of a transfer under Section 351 by a taxpayer who uses the cash receipts and disbursements method of accounting.[130] He attempted to change his method of

122. Treas. Reg. § 1.357-2(a) (1961).
123. See note 17 *supra* for definition.
124. 46 T.C. 604 (1966).
125. *See* Birren & Son v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940). Under Section 362(a), the accounts receivable will retain that same basis in the hands of the transferee corporation.
126. 46 T.C. at 608.
127. 1969-2 CUM. BULL. 53.
128. *Id.* at 53.
129. 470 F.2d 921 (2d Cir. 1972), *rev'g* 30 CCH TAX CT. MEM. 1124 (1971). For an excellent discussion of the case and the underlying problems, see Comment, *Bongiavanni v. Commissioner: Tax-Free Transfers of Payables by Cash Method Taxpayer Upon Incorporation*, 35 U. PITT. L. REV. 158 (1973).
130. See note 17 *supra* for definition.

accounting in the year he transferred his assets to his corporation.[131] Relying on *Raich*, the Tax Court rejected his change of method, forcing him to take a zero basis on his trade accounts receivable. As a consequence, the petitioner incurred a tax because his liabilities then exceeded the adjusted basis of his assets. The Second Circuit reversed giving a different definition of liabilities:

> [W]e believe that the word "liability" is used in Section 357(c) in the same sense as the "liability" referred to in the legislative history of Section 357(c). It was not meant to be synomyous with the strictly accounting liabilities involved in the case at bar. Section 357(c) was meant to apply to what might be called "tax" liabilities, i.e., liens in excess of tax costs, particularly mortgages encumbering property.... Any other construction results in an absurdity in the case of a cash basis taxpayer whose trade accounts payable are not recognized as a deduction (because he is on the cash basis) but whose "liabilities" (although unpaid) *are* recognized for purposes of Section 357(c).[132]

The Second Circuit based its conclusion on the intended purpose of the statute which encourages tax-free business reorganizations and on specific legislative history which avowed equalization of tax consequences.[133]

Notwithstanding the Second Circuit's decision, the Tax Court maintained its *Raich* stance in the recent case of *Wilford E. Thatcher*.[134] In *Thatcher*, a partnership transferred its assets and liabilities in a purportedly tax-free exchange, but the Tax Court found partial recognition of gain under the *Raich* interpretation of Section 357(c).

> The Circuit Court's holding in *Bongiovanni* cannot be reconciled with the language of Section 357(c); such provision is applicable when "the sum of the amount of the liabilities assumed, plus the amount of liabilities to which the property is subject" exceeds the basis of the property transferred. If the term "liabilities" was limited to liens, there would be no need to refer, in Section 357(c), to liabilities which are assumed as separate from those to which the transferred property is subject.[135]

While later cases have followed *Raich*,[136] *Thatcher* has been appealed by

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131. 30 CCH Tax Ct. Mem. 1124 (1971).
132. 470 F.2d at 923–24.
133. H.R. Rep. No. 1337, 83d Cong. 2d Sess. 4064 (1954).
134. 61 T.C. 28 (1973).
135. *Id.* at 36. An interesting dissent by Justice Hall noted that a taxpayer who transfers $1000 of trade receivables to an outsider will be liable for no income tax while "the same taxpayer making the same exchange with his wholly owned corporation will have $1000 of taxable income. Section 351, intended as a shield against recognition of gain on incorporation, thereby perversely becomes a sword to impose a tax where none would be due in an ordinary recognizing transaction." *Id.* at 42.
136. *See* David Rosen, 62 T.C. 11 (1974).

the taxpayer to the Ninth Circuit Court of Appeals.[137] Caution is advised pending that Court's determination of the case and possible submission to the Supreme Court to resolve a conflict between circuits. Meanwhile, the problem can be avoided by paying off liabilities prior to the Section 351 transfer.

BAD DEBT RESERVES

Another area of concern is where incorporating involves the treatment of bad debt reserves. Before the Supreme Court's decision in *Nash v. United States*,[138] the Commissioner sought to treat these reserves as a recovery of income under the "tax benefit rule."[139] The taxpayer, a partnership, had been using the reserve method of accounting for bad debts as prescribed by the Code.[140] When the partnership incorporated, the Commissioner determined a recovery of the amount in the reserve since the reserve was no longer needed.[141] Justice Douglas, who wrote the opinion, noted:

> Since the reserve for purposes of this case was deemed to be reasonable and the value of the stock received upon the transfer was equal to the *net value* of the receivables, there does not seem to us to have been any "recovery."...
>
> For these reasons the Court of Appeals in the *Schmidt* case held that although the "need" for the reserve ended with the transfer, the end of that need did not mark a "recovery" within the meaning of the tax benefit cases ....[142]

Justice Douglas' opinion considered the realities of accounting where the reserve for bad debts is merely a bookkeeping entry and has no separate existence.[143] Note that this case applies only to the transfer of *net* receivables or "the face value [of the accounts receivable] less the amount of the reserve for bad debts."[144] As a consequence, when the amount of the bad debt reserve *is* included in the receivables transferred, a recovery under the tax benefit rule will be recognized.

BASIS

The Code provides for basis of the stock to the transferor and the property to the transferee corporation. The basis of stock received will be the same as

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137. 9 CCH 1975 STAND. FED. TAX REP. 70,715.
138. 398 U.S. 1 (1970), *rev'g* 414 F.2d 627 (5th Cir. 1969).
139. This term was defined in the *Nash* case: "[T]hat a recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery." 398 U.S. at 3.
140. INT. REV. CODE OF 1954, § 166(c).
141. 398 U.S. at 3.
142. *Id.* at 4-5.
143. A modern term is "allowance for uncollectible accounts" to dispel the notion that cash is actually set aside. *See* W. MEIGS, A. MOSICH, & C. JOHNSON, ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS 271-72 (3d ed. 1972).
144. 398 U.S. at 4.

the basis of the property transferred for it, decreased by any boot received.[145]

> Suppose, for example, that a transferor surrendered property with a basis to him of $9000 and a fair market value of $15,500 in exchange for $2500 in cash, $1000 fair market value of boot, and stock and securities worth $12,000. Suppose that the securities were worth twice as much as the stock. The basis of the stock and securities would be determined as follows:

Basis of property given up	$9000
Less boot	−1000
Less cash	−2500
Subtotal	$5500
Plus gain recognized on the exchange	+3500
Basis of stock and securities	$9000
Allocated as follows:	
Stock	3000
Securities	6000

> Since the Transferor surrendered property with a basis of $9000 and received a total of $15,500 in cash, boot, stock and securities, he realized a gain of $6500, of which $3500 was recognized (i.e., the total of the $2500 cash and the $1000 fair market value of the boot). The boot received as its basis an amount equivalent to its fair market value—$1000.[146]

Similarly, Section 362 which governs calculation of basis to the transferee corporation gives the transferred property the same basis it had in the hands of the transferor increased by any gain which the transferor recognizes.

Basis may be a difficult problem for the partnership which plans to incorporate. A partnership may theoretically transfer to the corporation in three ways: (1) it can dissolve the partnership and transfer assets; (2) it can transfer assets directly without dissolving; or (3) it can transfer the partnership interests to the corporation in a tax-free transaction. Revenue Ruling 70-239[147] declares that these different methods have the same tax result and they will regard each situation as "a transfer under section 351 . . . of all of its assets subject to its liabilities. . . . The basis of the property acquired by . . . [the] corporation will be the same as its basis in the hands of the transferor partnership."[148] The ruling has been questioned in its application and criticized for its long-range effect on basis[149] particularly since the Code provides for complex basis computations for partners in

145. INT. REV. CODE OF 1954, § 358.
146. PAINTER § 2.3. For an example of allocation of basis, see note 117 *supra*.
147. 1970-1 CUM. BULL. 74.
148. *Id.*
149. *See* O'BRYNE & PENNELL 60-61; Rosen, *New Partnership Incorporation Ruling May Create Unforeseen Problems In Many Areas*, 33 J. TAX. 329 (1970).

particular situations.[150] No clarification has been issued on the possible consequences of this ruling, but an awareness of the problem may help to prevent some adverse effects.

LIQUIDATION

Since incorporation should be viewed with an eye toward saving money, the possibility of a return to the partnership or proprietorship should not be overlooked. While incorporation may be a tax-free event under Section 351,[151] the reverse generally constitutes a taxable situation. If for some reason, the corporate form proves too costly, or if for any reason liquidation occurs, the corporation will be liquidated with accompanying tax consequences. "[The] shareholders are treated as having exchanged their stock for the corporate assets, and the fair market value of the property received in the liquidation is compared with the basis of the stock to find the taxable gain or loss."[152] By reversing the process of incorporation, all the tax which was deferred by the tax-free transfer is now recognized and must be paid. A person confronted with this situation who changes back to the less intricate business form will not be in the same net position. He will be faced with a sizable tax bill. Attention to pertinent provisions of the Internal Revenue Code regarding liquidation[153] may mitigate the tax cost to some extent.

TAXABLE TRANSFERS

No treatment of incorporation would be complete without a discussion of taxable incorporation where the mandatory provisions of Section 351 are deliberately avoided.[154] This can be desirable where the corporation wishes to receive a stepped-up basis[155] on property with a high current market value and a low adjusted basis. Section 351 might also be avoided to recognize loss on the transfer. The best way to completely avoid the application of Section 351 is to fail to maintain requisite control.[156] "[S]tock that will not qualify as 'control' stock is that which is issued to someone who transfers only his services"[157] or who transfers an asset which does not fit the definition of property, to the new corporation.

If property is transferred for cash or short term notes, Section 351 also will not apply; however, the Commissioner might determine that the notes cause "thin incorporation" (i.e., an excess of debt to equity).[158] Then the

150. INT. REV. CODE OF 1954, §§ 731-32, 734, 736, 743.
151. *Id.* § 351; see discussion at p. 374 *supra*.
152. SOBELOFF at 95.
153. INT. REV. CODE OF 1954, §§ 331, 337.
154. BITTKER & EUSTICE ¶ 3.15.
155. When the property is transferred, the difference between its market value and original adjusted basis is taxed as gain; however, that gain is then added to the basis of the property. This steps up its basis and results in less gain when the property is subsequently transferred.
156. INT. REV. CODE OF 1954, § 351(a).
157. Robinson, *"Tax-Free" and Taxable Incorporation*, 28 U. FLA. L. REV. 207, 219 (1965).
158. A thin corporation results when the ratio of stockholders' debt to stockholders' equity is heavily unbalanced. The Commissioner generally determines debt to be stock in order to

Commissioner will declare the debt to be a form of stock which, as a consequence, impairs the corporation's ability to withdraw funds from the corporation.[159] Basis can be stepped-up within the bounds of Section 351 by transferring "boot" in addition to stock. Gain will be recognized on the boot and will also be attributed to the corporation's basis.[160]

Avoiding Section 351 has been made relatively unattractive by certain provisions which have special significance for the small corporation. Gain on transferred property which ordinarily would be eligible for capital gains treatment will be converted into ordinary income if Section 1239[161] is applicable. That section taxes as ordinary income, a sale or exchange of depreciable property between an individual and a corporation if he or his spouse, children, or grandchildren own more than 80 percent of the outstanding stock.[162]

Secondly, depreciation may be recaptured pursuant to Sections 1245 or 1250. Section 1245 applies to "any property which is or has been property of a character subject to the allowance which is either personal property or other property (not including a building or its structural components) but only if such property is tangible and has an adjusted basis."[163] All depreciation is recaptured and taxed as ordinary gain to the transferor of the property if Section 1245 applies.[164] Section 1250 provides for depreciation recapture on real property, but with less stringency than the recapture provisions of Section 1245. Under Section 1250 all depreciation on property held for less than one year is recaptured. Between one year and twenty months all depreciation in excess of straight-line is recaptured. If property has been held for at least twenty months and if an accelerated method of depreciation has been used, the excess depreciation over straight-line is recaptured with reduction of realized depreciation computed cumulatively at one percent per month from the date of twenty month holding period. After ten years the reduction diminishes the taxable depreciation to zero and the effects of Section 1250 recapture is negated.[165] This recaptured depreciation on real and personal property is the effect to the transferor for taking the stepped-up basis to the corporation.

Avoidance of Section 351 will also lead to recapture of the 7 per cent investment credit against taxes[166] on depreciated property.[167] When there is a "mere change in form of conducting a trade or business,"[168] which is the case in a Section 351 exchange, no investment credit is recaptured.

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disallow the corporate deduction of interest. *See* Taft v. Commissioner, 314 F.2d 620 (9th Cir. 1963).

159. If the debt is deemed to be stock, payment of the debt may come under the provisions of INT. REV. CODE OF 1954, § 302 (redemption of stock).
160. *Id.* § 362.
161. *Id.* § 1239; *see* Parker v. Commissioner, 376 F.2d 402 (5th Cir. 1967).
162. INT. REV. CODE OF 1954, §§ 1239(a), (b).
163. *Id.* § 1245(a)(3).
164. *Id.*
165. *Id.* § 1250.
166. Treas. Reg. § 1.46-1(a) (1965); *id.* § 1.47-1(a) (1968).
167. INT. REV. CODE OF 1954, § 38. Section 38 property is defined in Section 48(a)(1).
168. Treas. Reg. § 1.47-3(f) (1968).

When section 351 is avoided to recognize loss, it may be disallowed under the Code provisions which prohibit recognition of loss if more than 50 per cent of the stock of a corporation is owned directly or indirectly by an individual.[169] This effectively negates the reason for avoiding the tax-free transfer section which also does not recognize loss.

CORPORATE TAX ELECTIONS

Once incorporation is chosen, the new corporation should make certain practical tax elections. The first is selection of the fiscal year.[170] While "a new [corporate] taxpayer in his first return may adopt any taxable year which meets the requirements of Section 441 [the taxpayer must keep books and have an annual accounting period] and this section [Treas. Reg. §1.422-1(b) (3)]"[171] without obtaining prior approval, partnerships must adhere to more stringent regulations.[172] The choice is beneficial because by selecting the first taxable corporate year to come approximately one month after the individual's taxable year, the taxpayer can defer income for twelve to fifteen months. This election has special import for the seasonal business. "It often occurs ... that a corporation will begin operations near the end of a year so that the first calendar year would show a high seasonal gain. In such a case, extending the first taxable year beyond the end of the first calendar year would enable the corporation to offset its seasonal gain by a subsequent seasonal loss."[173] Similarly, tax may be deferred by ending the first taxable year just prior to the high income season.[174]

Generally, incorporation and the desire to end the taxable year occur in less than a twelve month period. When these goals coincide, advantage may be taken of the short taxable year as provided by the Code.[175] If anticipated income will be light while anticipated costs will be heavy in the first six months of the newly incorporated business, a short taxable year should be selected.

> Care must be taken in selecting the taxable year to weigh the best use of the losses to insure, if possible, that a 48 per cent benefit (22 per cent normal tax plus 26 per cent surtax disregarding the temporary surcharge) rather than a 22 per cent benefit, will be derived from it. Perhaps, in such a case, the first taxable year should be terminated at the end of the initial six months' loss period, with the expectation that the succeeding 12 months would yield sufficient otherwise taxable income in excess of $25,000 to

169. INT. REV. CODE OF 1954, § 267(a)(1); *see* SOBELOFF at 73.
170. See note 16 *supra* for definition.
171. Treas. Reg. § 1.441-1(b)(3) (1958).
172. *Id.* § 1.442-1(b)(2) directs that a partnership may only adopt the same taxable year of all its principal partners or a calendar year without obtaining prior approval. INT. REV. CODE OF 1954, § 706 and Treas. Reg. § 1.706-1(b) (1957) explicate in detail the requirements for the partnership taxable year.
173. 4 CCH 1975 STAND. FED. TAX REP. ¶ 2715.012.
174. *Id.*
175. INT. REV. CODE OF 1954, § 443(a)(2); Treas. Reg. § 1.443-1(a)(2) (1958).

absorb the loss carryover from the first short year, thus utilizing the losses at the combined normal tax and surtax rate of 48 per cent.[176]

Election of the fiscal year, however, should be carefully coordinated with the filing of the Articles of Incorporation since that year begins when corporate existence begins.[177] This election of the fiscal year should be made when the first tax return is filed and must be "on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year."[178] It should be noted that if no election is made, the taxpayer is relegated to a calendar year.[179]

The new corporation has an additional option: selection of its method of accounting.[180] Any traditional method may be used as well as less orthodox methods which may be tailored to the needs of a particular business.[181] The percentage of completion or the completed contract method, for example, is beneficial to a taxpayer whose business involves "long-term contracts"[182] which are executed and completed in different taxable years. The Service requires only that such method "clearly reflect income."[183] This concept includes "[a] method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business."[184] If the taxpayer's method does not clearly reflect income, the Commissioner may choose a method of accounting for the taxpayer, but it must be a reasonable method.[185] Once the accounting method has been chosen, it may not be changed without permission.[186]

Regardless of which method of accounting is used, the new corporation may amortize start-up expenses over a period of sixty months.[187] Start-up expenses or organizational expenditures are defined by the Code as "any

176. R. MOLLOY, FEDERAL INCOME TAXATION OF CORPORATIONS 26 (1972); see INT. REV. CODE OF 1954, § 172 and Treas. Reg. § 1.172-2 (1957) for pertinent Code sections on loss carryovers; 2 CCH 1975 STAND. FED. TAX REP. ¶ 1921 et. seq. gives a useful explanation of carryovers.
177. MD. ANN. CODE art. 23, § 131(b) (1973); see discussion at p. 370 *supra* for application to Subchapter S Corporations.
178. Treas. Reg. § 1.441-1(b)(3) (1958).
179. *Id.* § 1.441-1(4)(d).
180. INT. REV. CODE OF 1954, § 446; Treas. Reg. § 1.446-1(e) (1958).
181. Treas. Reg. § 1.446-1(c)(1)(iii) (1958).
182. Long-term contracts "means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." Treas. Reg. § 1.451-3(a) (1958).
183. INT. REV. CODE OF 1954, § 446(b); *see, e.g.*, Palmer v. Commissioner, 267 F.2d 434 (9th Cir. 1959); Schram v. United States, 118 F.2d 541 (6th Cir. 1941); G. E. Cotton, 25 B.T.A. 866 (1932), *acquiesced in*, XII-2 CUM. BULL. (1933); Joseph Stern, 14 B.T.A. 838 (1928), *acquiesced in*, IX-1 CUM. BULL. 52 (1930); Burgess Poultry Market, Inc. v. United States, 64-2 U.S. Tax Cas. 93,163 (E. D. Tex. 1964).
184. Treas. Reg. § 1.446-1(a)(2) (1958).
185. Russell v. Commissioner, 45 F.2d 100 (1st Cir. 1930).
186. INT. REV. CODE OF 1954, § 446(e).
187. *Id.* § 248(a); Treas. Reg. § 1.248-1(b) (1957) offers some examples of organizational expenses: "legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings; ... necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the State of incorporation."

expenditure which-(1) is incidental to the creation of the corporation; (2) is chargeable to a capital account; and (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life."[188] The election for this amortization must be made in the taxable year in which the corporation begins business and only if filed within the time prescribed by law.[189] Although less attractive than a large, ordinary income expense deduction in that vital first corporate year, amortization may provide a palliative for the inordinate impact of "organizational expenditures." Prior to the 1954 Code, organizational expenditures were not deductible from gross income.

CONCLUSION

The businessman who is contemplating incorporation of his small business should consider carefully the numerous sections of the Code applicable to the transformation from proprietorship or partnership to a corporation. Even more important is an evaluation of the long-range financial impact on the business as it expands within the corporate form. Only after a thorough analysis of the entire situation can a knowledgeable decision to incorporate be made.

Susan B. Watson

188. INT. REV. CODE OF 1954, § 248(b).
189. *Id.* § 248(c); Treas. Reg. § 1.248-1(c) (1957).