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James J. Fitzgerald Jr.

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TAX PROBLEMS OF SMALL BUSINESSES †

JAMES J. FITZGERALD, JR.*

WITH BUSINESS being carried on at the 1951 level, all business looks anything but small to those of us who practiced law during the depression. Relatively, the small business referred to in the title is the mill run of numerous businesses which would not qualify under the heading of big business.

To start with, mention should be made of the available forms of doing business with at least a hint of the income tax problems resulting from their use.

The most common available forms or structures for carrying on business are:

(1) Sole proprietorships;
(2) Partnerships;
(3) Corporations.

From an income tax standpoint the sole proprietorship form of doing business is not burdened with a separate income tax — the owner simply shows on his individual return a computation of the net income from the business and takes such income into account in computing his income subject to tax.

A partnership is compelled to take one step further and file a return, but the return is only a report form and no tax is assessed against the partnership on the same income shown in the partnership return. The distributable income of the partnership is included in the partner's individual return and the partner, like the sole proprietor, individually pays the income tax.

The corporation, however, is a separate entity for income tax purposes. It is subject to different rules for the determination of income and deductions and to a separate income tax.

An attorney faced with advising a client on the form of doing business should first carefully obtain all of the facts which will have a bearing on the selection of the form. He should be careful not to become so intrigued with certain tax considerations as to give advice which will not fit in with the taxpayer's overall picture. Frequently, the motivating facts in determining the form to be used will not be found in a consideration of the factors involved

† This is the text of an address delivered at an institute on tax problems conducted by the North Dakota State Bar Association in Bismarck, North Dakota, on November 14 and 15, 1951.

* James J. Fitzgerald, Jr., A.B., LL.B., is a member of the Nebraska Bar and the firm of Fitzgerald, Hamer, Brown and Leahy, Omaha, Nebraska.

in the contemplated business venture. To illustrate: If a client contemplated a business venture in which he was going to be sole owner, which would net him $10,000, undoubtedly the best business structure from a tax standpoint would be a sole proprietorship. If, however, this same client had outside income of $150,000 annually, the problem would be drastically changed and it could well be that the business could be better launched as a corporation. In such a case, the possibility of members of the family joining in a partnership in order to split the income should be probed.

Where profits of a corportion are small to the point where they provide only reasonable salaries or compensation to stockholders, the corporate tax is not of much concern and the parties can have the legal protection and advantages of a corporation without excessive tax cost.

As a general observation it would seem that the simplest form of doing business for the average client where the business is small is as a sole proprietorship. With the sole proprietorship, there is less complication as far as the client is concerned, in generally dealing with his property and even in directing its disposition by will. If some other method is to be used, there should be definite reasons for its use. These reasons usually become very apparent after a marshalling of all of the pertinent facts. Among the pertinent facts should be assumed earning figures furnished by the client. If the client's business is at all complicated, the lawyer should be very ready to consult with and work with the client's auditor or certified public accountant.

No question arises at the beginning of a sole proprietorship with respect to transfers of property to be used in the business. No transfers are necessary.

Where a partnership is being organized and the partners transfer property to the new entity, the general rule is that there is no tax on the contribution.[1] The only exception would seem to be where the contribution is in the form of installment accounts receivable by one reporting on the installment basis, in which event the contribution results in gain or loss.[2]

An exchange of property for corporate stock is a transaction in which gain or loss is realized. There are exceptions, the ordinary

[1] Edward B. Archbald, 27 B.T.A. 837 (1933), *aff'd* 70 F.2d 720 (2d Cir. 1934).
[2] Int. Rev. Code §44 (d); I.T. 3293, 1939-1 Cum. Bull. 183.

exception being § 112 (b) (5) of the Internal Revenue Code, which reads in part:

> "Transfer to corporation controlled by transferor. —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 immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially proportion to his interest in the property prior to the exchange. . . ."

Where a single owner of property takes all of the stock, no question of "control" could be raised. Where several transfer property to the new corporation, care should be taken that the securities received qualify under the "substantially in proportion" requirement, having in mind that the word property in the section includes money.[3]

If the corporation, as formed, is immediately to acquire, say pursuant to a contract, property for shares in addition to the property initially transferred, it is possible that the Commissioner will consider that the two transactions are integrated and should be considered together in determining whether the exemption furnished by § 112 (b) (5), *supra,* applies.[4]

The word "control" in the above section of the Code is defined as ownership of stock "possessing at least 80% of the total combined voting power" of all of the stock and 80% of the total of all other shares of the corporation.[5] The word "immediately" in the section means what it says and the status of ownership need not continue for any period if the persons in control were under no binding obligation to dispose of their shares previous to acquisition.[6]

After a transfer of property to a new entity, the basis to the transferor of his acquired interest depends upon usual principles. Where gain or loss was recognized, the transferor will have a new base; otherwise he retains his old base. This means, of course, that where the transfer was to a corporation for stock in a tax free organization under § 112 (b) (5), *supra,* the corporation takes the same basis for gain or loss and for depreciation and the like

[3] Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935); G.C.M. 24415, 1944 Cum. Bull. 219.

[4] W. & K. Holding Corporation, 38 B.T.A. 830 (1938).

[5] Int. Rev. Code §112 (h).

[6] Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942), *cert. denied* 317 U.S. 655 (1942).

as the stockholder had.[7] The stock received by the stockholder gets the same base as the property transferred to the corporation had.[8] If the transfer to the corporation was a taxable transaction, then transferor's base is the fair market value of the property transferred. The corporation's cost basis is the value of the stock measured by the value of the property exchanged for it.[9]

Where the transfer is to a partnership, no change in basis occurs. The partner keeps his same base and the partnership acquires the partner's base [10] except, as previously stated, where the contribution consists of installment accounts receivable. In the latter case, there is a change if the partner had been reporting gain on the installment basis, in which event the partnership base would be the fair market value of the obligation.

Unexpected results sometimes ensue where one partner contributes property to a partnership where his cost basis is low. The result is illustrated by an example given in a Treasury Department General Counsel Memorandum [11] as follows:

> "Suppose A owns a mill, having a basis of $10,000 in his hands, which has greatly appreciated in value while held by him. Assume that it had a value of $100,000 in 1928 when he entered into a partnership agreement with B, under which A contributed the mill worth $100,000, B contributed cash of $100,000, and they were to operate a mill business in which each was to share equally. Then suppose after the partnership was formed and before operations were begun, they sold the mill for $200,000 and invested their capital in another enterprise which they operated as a partnership enterprise.
>
> "Under the principles stated above, which establish the basis of the mill in the hands of the partnership at $10,000 (the basis to A), the partnership realized $190,000 income upon the sale of the mill for $200,000. Actually B's distributable share thereof is but $50,000 under the partnership agreement which includes the agreement that the mill was worth $100,000 when contributed, and that A, accordingly, be credited with that amount in his capital account with the firm. In other words, the effect of the agreement, so far as the above described transaction is concerned, was that A and B would share equally in any proceeds from the sale of the mill in excess of $100,000. As such excess in the stated case was $100,000, B was entitled to only one-half thereof, or $50,000, which was distributable to him. Manifestly, the remaining

[7] Int. Rev. Code §113 (a) (8).

[8] Int. Rev. Code §113 (a) (6).

[9] Reliance Investment Company, 22 B.T.A. 1287 (1931).

[10] Int. Rev. Code §113 (a) (13).

[11] G.C.M. 10092, XI-I Cum. Bull. 114 (1932).

> $140,000 must be regarded as distributable to A for income tax purposes, even though the partners considered and agreed to treat $90,000, the measure of appreciation in value while held by A, as partnership capital which was not subject to withdrawals. . . ."

If the above example were carried out in a situation where the sale price was less than partnership book cost but more than partnership basis, then you would have a gain to one partner and a loss to the partner not contributing the asset. Under sections 182 and 183 of the Internal Revenue Code, it would seem that there is only a loss or a profit for distribution, not both. The General Counsel Memorandum cited is based on a concept of unrealized appreciation which points to individual ownership of partnership assets contrary to the unit theory entertained by the courts and the concept apparently intended by Congress.[12] Despite the statement made in the Memorandum that its interpretation of "distributable" income "may not be varied by agreement between the parties," good judgment would seem to dictate the advisability of having the partners agree on a basis for adjusting income tax liability between them growing out of a difference between the contributing partners' cost basis in the property and the fair market value or book value at the date of contribution.

An incident to the formation of a partnership or a corporation is the right of the new entity to choose its own accounting year. This is usually done by a short first year and a return for such short year. Frequently this right furnishes an opportunity to divert income over into another year with resultant tax savings.

Where the lawyer is called in previous to the inception of the business venture, an analysis of all of the facts may show that a combination of two or even all three forms of doing business may produce the best results. Corporations with earnings not in excess of $25,000 are not yet subjected to the excess profits tax or the surtax, and the corporate normal tax is 30%. If a contemplated business venture can be broken down so that part of the venture is operated as a partnership with two married partners and part of the operation carried on in corporate form, the result will be a four way individual split of the partnership income (assuming joint returns by a husband and wife) and a corporate

[12] Helvering v. Walbridge, 70 F.2d 683 (2d Cir. 1934); Flannery v. United States, 25 F. Supp. 677 (D.Md. 1938), *aff'd* 106 F.2d 315 (4th Cir. 1939); Robert E. Ford, 6 T.C. 499 (1946).

tax of not in excess of 30%. In such a set-up, care should be taken to allow for some accumulation of earnings in the corporation, as, otherwise, the amounts paid out in dividends would be subject both to the corporate tax and to the individual tax on receipt of dividends. The transactions between such entities will have to be at arms length as the Bureau has the right, under the Code,[13] to reapportion income and deductions between controlled groups to prevent tax evasion or to properly reflect income.

One reason for the statement previously made that there should be a valid motivating reason for incorporating is that the corporate form is a more complicated form for most small businessmen. Frequently, because the small businessman does not understand various implications flowing from operating as a corporation, he may get into trouble if he acts without advice. A lawyer who sets up a corporation for tax saving purposes and who senses that the client may, if left to his own devices, not carry on as he should may benefit the client if he works out some arrangement for observing the client's operations which will keep him in close enough touch with the client's business to guard the client against some of the possible pitfalls. To illustrate: A client who owns a corporation which, in turn, owns real estate which has greatly appreciated in value might, if left to his own devices, have the corporation sell the real estate (thus incurring the capital gains tax on the sale) whereas he could better operate as a sole proprietorship under present tax law and could just as well have liquidated the corporation previous to the sale of the real estate and avoided what, in effect, would be a double capital gains tax on the appreciation in value of the real estate. Similarly, the client not appreciating the tax results may cause surplus to be paid out to himself and incur ordinary income tax on such pay out just because he feels that, since he owns all of the stock, he can do whatever he wishes with the assets of the corporation.

Much has been said about family partnerships and the tax troubles resulting from the Commissioner's refusal to recognize such partnerships for income tax purposes. With the going into effect of the Revenue Act of 1948, the accent was taken off husband and wife partnerships because such partnerships had inherent in them certain complications in property holdings and they were no longer needed for income tax purposes, since the 1948 Act allowed joint income tax returns by husband and wife resulting

[13] Int. Rev. Code §45.

in a genuine splitting of the income for purposes of computing the tax. With the changes in the Revenue Act of 1951, the partnership form can, with reasonable certainty, now be relied upon for aid in lessening the impact of the income tax to a family group. Specifically, the Revenue Act of 1951 added the following provision to the Internal Revenue Code section setting forth the definition of a partnership:

> "A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."[14]

Further, the following section was added to Supplement F dealing with partnerships, reading as follows:

> "In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons."[15]

Two points should be kept in mind in connection with this new section where the interest of a partner is represented wholly by a capital contribution. These are:

(1) A reasonable provision for compensation to partners rendering services to the partnership for the services rendered, and

(2) This distributive share of the partner should bear a proper relation to the distributable share of the other partners based on the capital contributed.

The North Dakota statutes provide for not only general but limited partnerships and a trust for a member or members of a family could well be a limited member of a limited partnership,

[14] Int. Rev. Code §3797 (a) (2).

[15] Revenue Act of 1951, §340 (b).

with the result that such planning would furnish an additional income split and could also fit in to reduce the estate tax of the donor.

Where there is a husband and wife partnership, part or all of the wife's interest in the partnership could furnish the assets for a family trust with a change from general to limited partnership. Depending upon local laws with respect to the obligation of a wife to support the children, the income of the trust from the partnership might even be distributed to beneficiary minor children without such distributed income being taxable to the father.

If you feel that a limited partnership is the answer to your client's problem, then the partnership agreement should be carefully drawn to avoid the possibility of the entity being treated as an association taxable as a corporation. The Internal Revenue Code defines a corporation as:

> "The term 'corporation' includes associations, joint stock companies, and insurance companies." [16]

The regulations provide:

> "A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law." [17]

The Commissioner of Internal Revenue is not bound to recognize a limited partnership as valid simply because the entity may be a valid limited partnership under state law. For income tax purposes the federal revenue laws control. Taxpayers were sustained in claim of right to partnership treatment by a limited partnership organized under New York law in *Glensder Textile Co.*[18] and anyone drafting a limited partnership agreement would do well to read that decision.

With the increase in corporation normal tax to 30% and surtax to 22% and the return of the excess profits tax adding another 18%, many businessmen are saddled with a corporate entity which

[16] Int. Rev. Code §3797 (3).

[17] Regs. 111, §29.3797.5.

[18] 46 B.T.A. 176 (1942).

is currently expensive taxwise. An example may serve to illustrate the effect of the new rates. Without considering excess profits tax, the normal and surtax rates for corporations take a 52¢ bite out of each $1.00 of corporate income. A husband and wife on a joint return can take $76,000 in income under the 1951 Act before their tax equals 52¢ on each $1.00 of income. Further, a husband and wife on a joint return can take $25,000 in income before the tax bite equals 30¢ out of each dollar of income.

The solution to the burdensome corporate taxes may be a change in business forms and probably the new form will be a partnership. What is the picture on a liquidation of a corporation? The liquidation of a corporation does not result in gain or loss to the corporation liquidated,[19] but the ordinary liquidation of a corporation owned by individual stockholders is a taxable transaction as far as the stockholders are concerned. The individual stockholders have taxable gain or deductible loss depending on whether they receive from the liquidation more or less than the cost basis to them of their stock. The transaction is the same as if the stockholder had sold his stock for the cash obtained, plus the fair market value of any assets received.[20] If a stockholder has held stock for over six months, he gets the benefit of long term capital gains treatment. The corporation can be so liquidated whether it has one or more stockholders. The liquidation can be into a new partnership – general or limited.[21]

If a decision is made to liquidate a corporation, the first step is for the stockholders to pass a resolution authorizing and directing the liquidation. Within thirty days after the date of this resolution, an Informtaion Return (form 966) must be filed with the Commissioner of Internal Revenue, Washington, D. C. If the business is to be continued by a partnership, the liquidation can be immediate and the business continued without interruption by the partnership.

Care should be taken at the time of liquidation to establish the value of the assets received in liquidation. Just how careful and meticulous you should be in this regard depends on the facts. Generally, if real estate is involved, appraisals of the real estate reflecting its market value as of date of liquidation should be obtained in writing and preserved. Likewise, if machinery and equip-

[19] Regs. 111, §29.22 (a)–20.
[20] Int. Rev. Code §§111 (c), 115 (c).
[21] P.H. Par. 9210 (1951).

ment are involved, similar apraisals should be obtained. Of course, the corporate operation will have to be closed off to obtain the basis for a final return. This will usually mean an inventory must be taken.

A further word about appraisals. Although the higher the appraisals the greater the gain and therefore the tax to the stockholder, it is not usually advisable to try to hold the amount of the appraisal down on depreciable property and sometimes inventory where the business is to be continued in another form. The stockholder obtains a new base at the time of liquidation for the assets received. The old cost basis to the corporation simply dissolves and disappears. Let us assume a corporation had machinery on its books at a depreciated cost of $30,000, which it was depreciating at about $3,000 a year or 10% a year. At the time of liquidation to a partnership let us assume that the fair market value of the machinery was $60,000 and that 10% was a proper rate of depreciating, then this same equipment would add $3,000 to the depreciation deduction allowable to the partnership. If the appraisal of the equipment was held down, the stepped-up base to the partnership would have been less, and, therefore, the depreciation allowance to the partnership would not have been as great and, consequently, the distributable income to the partners would be more and, therefore, the partners' income tax would be more. The partners, in other words, pay the 26% capital gains tax and, in return, through a ten year period, get the benefit of the reduction in income tax flowing from the greater depreciation allowed on the higher cost basis. Since the saving comes off of the top individual income tax bracket, it can be a worthwhile savings. A single individual reaches a 27% bracket after $4,000 of income and a husband and wife on a joint return after $8,000 of income. If a single individual has income in 1951 of $45,000, he will have reached a 73% tax bracket, forty-seven percentage points higher than the capital gains rate. Hidden inventory values, if kept hidden in the liquidation, may ultimately convert into normal income and increase such income.

In the event the business is to continue after the liquidation in any form, there may be a question of the existence and valuation of good will. The Bureau tries to use a formula to value the supposed good will. Under this formula, average earnings for the preceding five years are determined. From this figure is deducted 8% of the average tangible assets and the difference is capitalized at 15% (or 6½ times as a practical matter). This formula gives some startling results. To illustrate:

Assume average earnings for five years of	$50,000
Average tangible assets $300,000 x 8%	24,000
Difference attributable to good will	$26,000
Capitalized at 15%	$173,000

The client might be faced with a proposed deficiency of 26% of $173,000, or $45,000.

Where the client has just purchased the stock of the corporation and immediately liquidates it, there usually is no great problem because the purchase establishes the market price of the assets and the problem is more one of allocation of the purchase price among the assets received rather than ascribing values to individual assets with no regard for the total. In other words, the purchase price acts as sort of a ceiling on the combined values ascribed on liquidation to the individual assets.

As to the Bureau's formula, taxpayers have fared well in refusing to agree to deficiencies based thereon.[22] Successful defenses to the claim of existence of good will have been presented in the following situations:

(1) Automobile agency with nonassignable franchise.

(2) Success of business due to special skill of chief stockholders.

(3) Success of business primarily attributable to the ability, personality and reputation of one stockholder.

(4) Highly competitive businesses.

(5) Sales of similar businesses on an inventory basis.[23]

This general problem is factual and really is no different than the valuation of possible good will encountered by attorneys in estate tax returns where decedent operated a business as a sole proprietor or as a member of a partnership at the date of death.

In discussions dealing with corporate liquidations, the possibility is to be noted that the liquidating distribution may be construed as a dividend and therefore taxable as ordinary income. There would seem to be no real danger of such result in the ordinary situation where the corporation has been in existence for a few years, since the regulations specifically provide:

> ". . . A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of

[22] Rabkin & Johnson, Federal Income, Gift and Estate Taxation §23.02.

[23] Rabkin & Johnson, *supra*, note 22.

> a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend."[24]

If the corporation is a new corporation, care should be taken to examine the provisions of the special section relating to collapsible corporations [25] and to the broadening of the definitions of such corporations in the Revenue Act of 1951.[26] Generally, the law prevents the formation of a corporation for the production of a motion picture, construction of houses, or manufacturing of goods and then a liquidation of the corporation before the corporation sells the thing produced and treatment of the gain as long term capital gain. The present law prevents such practice by making the gain from sale or exchange of the stock (including liquidation of a corporation) ordinary income to the stockholder who owns more than 10% of the corporation's stock. The loophole closed by the present law as to corporations is still apparently open to partnerships. If a partnership builds houses and has a potential but unrealized profit, a partner can sell interest in the partnership and possibly obtain the benefit of capital gains treatment on the difference.[27]

Attention should be called to the fact that the remarks already made about carrying on a business through multiple units — *i.e.*, two or more corporations or other combinations, had reference to the beginning of a business. If a client already has a corporation and wants to split it up into two or more corporations, he may have trouble in getting more than one surtax exemption and minimum excess profits credit because of §121(f) of the Revenue Act of 1951, which provides that if property is transferred by a corporation to a new corporation after January 1, 1951, and the old corporation or its stockholders are in control of the new cor-

[24] Regs. 111, §29.115-9.
[25] Int. Rev. Code §117 (m).
[26] Int. Rev. Code §326.
[27] G.C.M. 26379, 1950-1 Cum. Bull. 58.

poration after the transfer, these credits shall not be allowed to the new corporation.

> "unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not the major purpose of such transfer." [28]

The Revenue Act of 1950 gave stockholders an optional method of taxing gains on liquidation of a corporation where the liquidation is accomplished within one month in 1951. [29] The Revenue Act of 1951 continues this same optional method past 1951. Essentially, through electing such optional method, the stockholder can postpone any tax on appreciation of property of the corporation, but must pay a tax as on receipt of a dividend to the extent

> "of his ratable share of the earnings of the corporation accumulated after February 28, 1913." [30]

It is apparent that such an elective method would not be beneficial where earnings and profits are considerable.

If a corporate form for business operation is used by the small businessman, he should guard against two statutory pitfalls. One is §102 of the Internal Revenue Code, which is the section providing a penalty in the form of a tax on the accumulation of corporate earnings in the corporation beyond the reasonable needs of the business. With increased inventory costs, there is currently not too much to worry about from §102 for the average corporation. I am influenced merely to mention this section, without elaboration, because it is a much discussed section and there are numerous worthwhile articles and comments thereon which are readily available to those who wish to pursue the matter further. Keep in mind that §102 should not be ignored, particularly where the corporation is a closed corporation. The other statutory pitfall is §500 *et seq.* of the Internal Revenue Code, which imposes the surtax on personal holding companies. Enough should be said about these sections to call them to your attention. In order to fall into the personal holding company trap, there are two requirements:

(1) The gross income requirement;

(2) The stock ownership requirement.

The small corporation usually is one with its stock closely held and, therefore, one of the two requirements for a corporation to qualify as a personal holding company is usually already met. This requirement is set forth in the following statutory language:

[28] Revenue Act of 1951, §121 (f), amending Int. Rev. Code §15 (c).
[29] Int. Rev. Code §112 (b) (7).
[30] Int. Rev. Code §112 (b) (7) (E) (i).

> "Stock ownership requirement. — At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals." [31]

This stock ownership requirement is broadened further by the provisions of a later section which provides that stock owned by corporations, partnerships, estates or trusts shall be considered as proportionately owned by its shareowners, partners or beneficiaries and by the provision that an individual shall be considered as owning the stock owned directly or indirectly by or for his family or by or for his partner, the family including his brothers, sisters, spouse, ancestors and lineal descendants. [32]

The second, or gross income requirement, is met if at least 80% of the gross income for the taxable year is personal holding company income. Personal holding company income generally consists of dividends, interest, rents and royalties with the provisions, however, that if rents or royalties consist of over 50% or more of the gross income, the rents or royalties are not then considered personal holding income. From the classification of income it is immediately clear that if the income results from an operating business, the income will not be personal holding company income. Whenever you have a corporation engaged in investing money, watch out for the personal holding company pitfall. If a corporation sells its operating business taking cash, which it later invests, or stocks or securities, then it can quickly be converted so that it will be a personal holding company for that year. This is something the lawyer should guard his client against or warn him of. Because this change of status frequently follows a sale of business assets or some change which should require the aid and help of a lawyer, the lawyer usually is close enough to see trouble ready to develop if he has in mind the possibility thereof. Too frequently, in the last several years, corporations became personal holding companies without the stockholders being aware of the fact and while distributing the income may avoid all or most of the surtax imposed, the penalties for failure to file a personal holding company return may not be avoided.

Many clients will still have reason to choose to do business through a corporate entity, particularly where the income will not exceed $25,000 a year and, therefore, the corporation will not, under present law, have to pay more than the normal corporate

[31] Int. Rev. Code §501 (a) (2).
[32] Int. Rev. Code §503.

tax of 30%. The tax rate itself will have an appeal for the client with large income from other sources. This corporate 30% tax offers additional attraction if the corporation can owe money and, therefore, have a good and sufficient reason for not paying out dividends on which client would have to pay another tax individually. This leads to what has become known as the "thin" corporation — a corporation with thin equity or capital and heavy debt. Recently, the Tax Court was called upon to decide whether interest paid by a corporation to stockholders on loans purportedly made by the stockholders to the corporation was a proper deduction to the corporation in determining its income. The facts showed that the stock of the corporation was sold to the stockholders at $5 per share and that the total capital received by the corporation was $75. The stockholders then loaned the corporation a total of $75,000, each stockholder loaning in proportion to his stock, the loans bearing a 1000 to 1 relationship to the value of the stock. The Tax Court in a memorandum opinion handed down September 28, 1951, held the loans were in reality capital contributions and that the purported interest payment was a dividend payment.[33] Such facts probably warranted the decision handed down. Clearly, a 1000 to 1 ratio of debt to capital is unrealistic and should not and will not fool anybody. The $64 question is where *is* the line to be drawn between debt and capital?

The following may be of some help:

(1) In the case of *Talbot Mills v. Commissioner,*[34] the question again concerned the deduction of interest. A reorganization took place pursuant to which the $500,000 common stock capitalization was changed to $100,000 common stock and $400,000 of registered notes, each stockholder owning the same proportion of stock and notes. The Supreme Court held it could not review the Tax Court decision because of the *Dobson Rule,* but took occasion to state:

> ". . . As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure."

The Court further indicated that, in such case, the decision should depend upon the facts in each case.

(2) A case analysis indicates as much debt to stock as 4.8 to 1

[33] Kipsborough Realty Corporation, Par. 51, 291 P-H. Memo. T.C.
[34] 326 U.S. 521 (1946).

has been held good, whereas a 29 to 1 ratio has been held excessive.[35]

(3) Where the terms and conditions of the obligations rêsemble stock more than bonds, they may be held equivalent to stock.

In planning, the best advice is to be:

(1) Reasonable and realistic about the whole set up. If indebtedness is over and beyond what could ordinarily be borrowed from one or another outside source, the debt should be trimmed down.

(2) The form of the instrument should unequivocally point to whether it is a bond or not. Hybrid securities may prove very troublesome.

(3) Have stock and debt owned by different persons if possible – at least keep ownership of stock and debt from being in the same proportion as to each stockholder. Under present law, having the debt in the wife's name where the husband owns an equity should help.

(4) Frequently, a good result can be obtained by several transactions. The corporation first starts with just the business leasing real estate and possibly other assets which it can use. As time goes on, and the corporation develops surplus, it can then purchase the real estate and the other assets useful in its business. Before relying on such a plan, you should examine the provisions of §328 of the Revenue Act of 1951 which makes gain from sale of property, which in the hands of the transferee would be subject to the allowance of depreciation, subject to treatment as ordinary income and not as capital gain income. This result ensues where the sale is made by an individual to a corporation, when 80% in value of the corporation's outstanding stock is owned by the seller, his spouse or his minor children or minor grandchildren.

Where the income of the corporation does not exceed $25,000, the capital structure of the corporation makes no difference as far as excess profits tax is concerned. This results from the $25,000 minimum credit under the excess profits provision.[36] Where, however, excess profits net income exceeds $25,000, then the capital structure does make a difference if excess profits credit is based on the invested capital credit option, since the credit is 12% of invested capital.[37] Borrowed capital is includible in that credit

[35] Brown, Payment on Indebtedness to Stockholders, New York University Seventh Annual Institute on Federal Taxation.

[36] Int. Rev. Code §431.

[37] Up to $5,000,000. See Int. Rev. Code §437 (a).

only to the extent of 75%.[38] In other words, borrowed capital will only convert into three quarters of the benefit of equity capital.

The small business is frequently owned by two or three individuals, each of whom works full time in the business. Usually, earnings are plowed back and very frequently the owners have all of their financial worth, except their home, in the business venture. Death of an associate gives rise to a real problem. If the business is a partnership, the death may result in dissolving the partnership. If a corporation, the family of the deceased may be left with stock which pays little or no dividend in a corporation from which the owners are taking out most of the profits in salaries. The problem should be anticipated by the parties entering into a buy-sell agreement.

In the ordinary situation, where the parties to such agreement do not have sufficient assets to buy without help, life insurance is coupled into the buy-sell arrangement. Insurance, in most cases, offers a good answer because members of a partnership or closed corporation have insurable interests in each others' lives.[39] The proceeds of the policies paid by reason of death come at the right time and are not diluted by tax as the proceeds are not taxable as income.[40]

Premiums paid for life insurance to fund such an agreement are not deductible for income tax purposes.[41] The premium costs are also not deductible as ordinary and necessary business expenses.[42] This holds true whether the premiums are paid by an individual, a partnership or a corporation.

The insurance should not be made payable to the estate of the deceased, since proceeds of life insurance are included in the estate of a decedent for Federal Estate Tax purposes:

> "to the extent of the amount receivable by the executor as insurance under policies upon the life of the decedent." [43]

Further, the proceeds of insurance on decedent's life are also includible in decedent's estate if the beneficiary is other than decedent's estate in the event decedent, directly or indirectly, paid the premiums or if decedent possessed, at the time of death, any

[38] Int. Rev. Code §437 (b) (2) (c).

[39] Rahders, Merritt & Hagler v. People's Bank, 113 Minn. 496, 130 N.W. 16 (1911); Keckley v. Coshocton Glass Co., 86 Ohio 213, 99 N.E. 299 (1912).

[40] Int. Rev. Code §22 (B) (1).

[41] Int. Rev. Code §24 (a) (4).

[42] Joseph Nussbaum, 19 B.T.A. 868 (1930).

[43] Int. Rev. Code §811 (g) (1).

incidents of ownership.[44] The reason for stressing this point is that the value of the business interest would be included in decedent's estate and, under the present law, the estate might be compelled to pay a tax on the insurance proceeds and the value of the interest in the business. If premiums are paid by a partnership under a survivor-purchase agreement, the proceeds will probably be includible in decedent's estate because the premiums were paid, directly or indirectly, by decedent.

Where an agreement provides for insurance to be paid to decedent's wife but that the surviving partner is to get the benefit of such insurance proceeds by way of reduction in cost to him of decedent's interest in a partnership, a question is raised as to the survivor's cost basis. One case held that the amount of such proceeds could not be added in determining the surviving partner's cost basis in the interest so acquired.[45]

Where a corporation is involved and the corporation pays premiums on insurance on a stockholder's life with the proceeds payable to the stockholder's estate, the premium payments may be construed as dividends taxable to the stockholder.[46]

With these suggestions of danger points, what constructive suggestions can be made? The best suggestion is to have the individual who will be the purchaser take out and own the policy on the life of the other party. By following this method, the individual who must pay the purchase price is the one who gets the proceeds from the insurance company. Decedent's estate is not involved. The purchaser will pay the full price himself and he will have no cost basis problem.

In the small partnership, the buy-sell agreement is a comparatively short and simple agreement, but includes a binding agreement to buy and to sell. It should contain a definite agreement as to price whether the price is tied to book value or to a formula pursuant to which the price is to be ascertained. The payment of the agreed purchase price is guaranteed by insurance which each partner agrees to maintain on the life of the other. As the amount involved or number of partners increases, usually a trustee is included whose duty it is to hold the insurance policies and collect and apply the proceeds.

A buy-sell agreement for stockholders may be essentially the

[44] Int. Rev. Code §811 (g) (2).

[45] Paul Legallet, 41 B.T.A. 294 (1940).

[46] Paramount Richards Theater v. Commissioner, 153 F.2d 602 (5th Cir. 1946).

same as for a partnership. It may be more complicated by reason of the number of stockholders involved. Where more than one stockholder has a right to purchase, care must be taken in working out the proportionate ownership which will result after the purchase is consummated. For corporations, there is another possibility and that is an agreement providing for a purchase and retirement of the deceased stockholder's shares by the corporation. This arrangement does not disturb the relationship of the remaining stockholders. Their percentage ownership is increased by the stock retired but the relationship of all of the surviving stockholders among themselves is not disturbed. In North Dakota, there is the requirement that the purchase of a corporation's own shares must be out of surplus. If the corporation has no surplus, such plan will be of no avail, but insurance proceeds on the deceased stockholder payable to the corporation may create the needed surplus.[47]

[47] Greater New York Carpet House v. Herschmann, 258 App. Div. 649, 17 N.Y.S. 2d 483 (1940).

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