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A "NEW LOOK" FOR MESSRS. SMALL AND SMALLER BUSINESS

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THE recession year 1958 found Congress in a mood to "aid and encourage small business"[1] through more favorable tax treatment. The thrust of the ensuing legislation touched in varying degrees the whole life span of a modest enterprise, from organization through liquidation. The focus here, however, will be confined to a consideration of the practical impact of the recent statutory changes on the organizational and ordinary operational phases of such a business.

By manipulating two well-established principles of our income tax structure, Congress sought to assist both profitable and temporarily unprofitable businesses to obtain additional liquid funds with which to meet their respective needs. An extension from two to three years in the period for which a net operating loss could be thrown back,[2] the purpose being to aid the already established but temporarily unprofitable business by increasing immediate refund possibilities, was complemented by the adoption of a more favorable depreciation arrangement for the year in which depreciable assets are acquired.[3] This latter concession will obviously be of immediate value to any currently profitable undertaking. Since the increased deduction immunizes a corresponding amount of income from tax, the differential in tax will serve as an immediate source of available funds. Benefit

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1 See H. Rep. 2198, 85th Cong., 2d sess., p. 2 (1958).

2 See I.R.C., §172(b)(1)(A), as amended by §203, Small Business Tax Revision Act of 1958, 72 Stat. 1678. The change applies to a net operating loss for any taxable year ending after December 31, 1957.

3 See I.R.C., §179, added by §204, Small Business Tax Revision Act of 1958, 72 Stat. 1679.

from the increased depreciation allowance will also affect any currently unprofitable undertaking which can pass through or carry back an increased net operating loss.

The congressional quest also to increase the flow of long-term investment capital into small business focused attention on that provision in existing law which treated loss on the sale, exchange or worthlessness of corporate stock as a capital loss, restricting deduction against *ordinary* income in the best of circumstances to $1,000 per year for six years.[4] For the asserted purpose of increasing the flow of private funds into small business, new section 1244 was added,[5] calling for ordinary loss treatment where the original holder of stock in a "small business corporation"[6] sells or exchanges the stock at a loss.[7] To qualify, "section 1244 stock" must be issued pursuant to a plan adopted after June 30, 1958, at a time when no portion of a prior offering is outstanding, and must be issued for money or other property but not other stock or securities.[8] Specified limits regarding the capital structure of a "small business corporation" must be satisfied at the time of the adoption of the plan for issuing qualifying stock.[9] Since these limitations on capital structure apply only as of the date of adoption of the plan, it is clear that the corporation's capital structure may subsequently increase in amount. This preferential tax treatment to investors

4 I.R.C., §§1211(b) and 1212.

5 Section 202, Small Business Tax Revision Act of 1958, 72 Stat. 1676.

6 The corporation must, for the period of operation up to five years preceding the date of loss on its stock, have derived more than 50% of its gross receipts from sources other than royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities. I.R.C., §1244(c)(1)(E).

7 In recognition of business needs for adequate long-term financing, Congress also passed the Small Business Investment Act of 1958 [72 Stat. 689], authorizing the creation of "small business investment companies" to provide equity capital for small business concerns. For this program to attract sufficient private funds, certain tax benefits were thought to be needed. Consequently, §§1242 and 1243 were added to the Internal Revenue Code [§57, Technical Amendments Act of 1958, 72 Stat. 1645], calling for ordinary loss treatment for a stockholder of a "small business investment company" who incurs a loss on the sale, exchange or worthlessness of stock held in the company, and ordinary loss treatment for the "small business investment company" itself on losses incurred on the sale, exchange or worthlessness of convertible debentures acquired by such company. In addition, "small business investment companies" are permitted a full 100% deduction for dividends received from other domestic corporations. The companies are apparently subject to the personal holding company provisions, however. See Rev. Rul. 59-69, Int. Rev. Bul. No. 1959-10, p. 18.

8 I.R.C., §1244(c)(1).

9 The total stock offering must not exceed $500,000 and the sum of the stock offering plus the equity capital of the corporation must not exceed $1 million. I.R.C., §1244(c)(2).

of such a corporation is limited further in that the aggregate loss deduction allowed under section 1244 shall not exceed $25,000 per taxable year, or $50,000 per year in the case of a husband and wife filing jointly.[10]

Another statutory change designed to facilitate accumulation of investment capital will be of importance primarily to the currently profitable incorporated business. Such a corporation is the beneficiary of a newly-adopted increase in the minimum amount of profits which can be retained over the years without any fear of running afoul of the penalty tax on unreasonable accumulations. Now the guaranteed minimum has been fixed at $100,000.[11]

Finally, both profitable and unprofitable enterprises will benefit from the injection into the code of a wholly new concept, hereinafter described as a section 1371 corporation.[12] A decision was finally reached to allow certain enterprises, though profitable, to use the corporate form without suffering the corporate tax, the income to be passed through to the stockholders whether or not distributed. Coupled with this was the notion that operating losses incurred by such a corporation should also pass through and be available as offsets against the stockholders' incomes.

Of the foregoing stimulants, only two warrant further detailed consideration. These, the new depreciation provision and the authority granted to small corporations to pass-through operating losses and taxable income while avoiding the corporate tax, can be best understood in the light of a realistic setting.

Introducing Messrs. Small and Smaller Business. Mr. Small Business is the sole stockholder and the chief salaried officer of one quite profitable though modest enterprise, Old Company, Inc. A former employee, Mr. Smaller Business, has just inherited a limited amount and has succeeded in inducing Small Business to participate in the establishment of a quite separate manufacturing operation. The joint effort will require a building and equipment. To reduce the initial capital requirements, arrangements have been made for the new enterprise to purchase some

[10] I.R.C., §1244(b).

[11] See I.R.C., §535(c)(2), as amended by §205, Small Business Tax Revision Act of 1958, 72 Stat. 1680.

[12] See I.R.C., subchapter S, §§1371-1377, added by §64, Technical Amendments Act of 1958, 72 Stat. 1650.

office equipment which had been used by Old Company. The two men anticipate that it will take the new enterprise a year or two to establish itself, with operating losses likely to be incurred during that period. While Small Business' interest in Old Company provides a substantial source of income to him, Smaller's salary will constitute his only source of livelihood.

When the new undertaking finally moves out of the red, the two then expect to expand operations out of current profits, foregoing dividends during the expansion period. Since the size of the marketing area circumscribes the expansion potential of the plant, and because of Smaller's desire to upgrade his standard of living within a few years, it is understood that when the business begins to level off—an anticipated matter of six or seven years—a substantial part of the then current profits will be distributed annually.

How should their plans be affected by the new depreciation and tax-form provisions?

I. ADDITIONAL FIRST-YEAR DEPRECIATION

In General. Apart from defense-inspired arrangements,[13] Congress has now twice manipulated the depreciation provision for the asserted purpose of aiding business. In 1954, the degree of permitted acceleration in the depreciation deduction allocable to *new* property was increased from 150 to 200 percent of the rate afforded by the straight line method.[14] The aim, so it was said, was to help maintain the then high level of investment and to encourage an even greater expansion of business activity.[15]

In the less favorable economic climate of 1958, Congress rejected a suggested extension of the 1954 code's accelerated rate to acquisitions of *used* property.[16] Turned aside also was a proposed maximum five-year write-off for all depreciable property.[17] But it did agree to permit a 20 percent *additional* depreciation allowance for certain qualified property, used as well as new, during the first year in which regular depreciation would be

[13] See I.R.C., §168.

[14] See I.R.C., §167(b)(2).

[15] S. Rep. 1622, 83d Cong., 2d sess., p. 26 (1954).

[16] See S. Rep. 1237, 85th Cong., 2d sess., p. 15 (1958); H. Rep. 2632, 85th Cong., 2d sess., p. 42 (1958).

[17] See H.R. 5635, 85th Cong., 1st sess. (1957), and H. Hearings before Committee on Ways and Means on General Revenue Revision, 85th Cong., 2d sess., p. 39 (1958).

taken on such property.[18] New section 179 will actually be meaningful only to little enterprises, for a separate ceiling which confines the deduction to property with an aggregate cost not exceeding $10,000 per taxpayer (or $20,000 in the case of a husband and wife filing jointly)[19] deprives the provision of any real significance to an industrial giant.

While the primary intention underlying this amendment was to benefit small businesses by increasing the *immediate* availability of funds for working capital and expansion purposes,[20] three alternative *ultimate* effects may follow, depending on the circumstances. One is that the provision will serve only to postpone the timing of tax reckoning. The additional first-year allowance, when applied to a particular asset, will have the complementary effect of reducing the depreciation deduction which can be taken in subsequent years, thereby increasing the amount of taxable income in those later years. Where qualified equipment is purchased every year, however, the overall effect will be permanently to postpone the tax on an amount at least equal to the first year increase allowed when section 179 is combined with regular depreciation. A final alternative effect, occasioned by a premature sale, is to be discussed more fully later. It is enough to say here that the problem involves what perhaps was an unintended, and certainly is an unwarranted, opportunity to convert ordinary income into capital gain.

Limitations Relating to the Character of the Property. Small and Smaller Business will not be able to apply this new provision to the building which they propose to acquire, for the benefit is expressly applicable only with regard to "tangible *personal* property" which is otherwise subject to the regular allowance for depreciation.[21] In this respect it differs from the older accelerated depreciation methods, as both the double declining balance method for *new* property and the 150 percent declining

[18] Section 204 of the Small Business Tax Revision Act of 1958, 72 Stat. 1679, adding I.R.C., new §179. I.R.C., §179(a) indicates that the additional 20% first-year allowance may be taken at the election of the taxpayer, and §179(c) provides for the time for making the election, which is irrevocable. The additional allowance is to be computed without regard to the salvage value of the property. See H. Rep. 2198, 85th Cong., 2d sess., p. 15 (1958).

[19] I.R.C., §179(b).

[20] See H. Rep. 2198, 85th Cong., 2d sess., p. 3 (1958). The estimated revenue loss for the first full year of operation under §179 was $175 million. Id., pp. 5-6.

[21] I.R.C., §179(d)(1).

balance method for *used* property are available for *all* tangible property otherwise justifying a depreciation allowance.[22] While the new provision will be available with regard to any new factory equipment to be purchased, it is also applicable to the purchase of the *used* office equipment. It is immaterial, according to the language of the new section 179, whether the taxpayer is the original or a subsequent user of the property.[23]

Limitations Relating to the Method of Acquisition. As the benefit applies to "purchases" of personalty,[24] the taxpayer will fall short of the mark if the property is acquired by gift or inheritance, or even when bought if the vendor is within the prohibited class of related persons.[25] The obvious aim is to preclude unwarranted multiplication of the benefit. However, the purchase by our joint enterprise of office equipment from Old Company, Inc., will not be disqualified, for the facts do not involve the prohibited degree of relationship under the governing rules. In the setting of interlocking arrangements, these rules are geared to the traditional "more-than-50-percent" standard of existing section 267.[26]

Limitation Relating to Useful Life, and the Opportunity for an Unwarranted Benefit. To qualify for the new section 179 allowance, the purchased property must have a useful life of at least six years.[27] Though no regulations have yet been issued interpreting the new provision, regulations regarding normal depreciation under section 167 state that "useful life" is "the period over which the asset may reasonably be expected to be useful *to the taxpayer* in *his* trade or business or in the produc-

22 See I.R.C., §167(b) and (c), and Rev. Rul. 57-352, 1957-2 Cum. Bul. 150. See also illustration, Treas. Reg. §1.167(c)-1(b) (1956).

23 H. Rep. 2198, 85th Cong., 2d sess., p. 5 (1958). It should be clear that an election to take the §179 additional first-year allowance does not prevent use of accelerated depreciation for otherwise qualified property.

24 I.R.C., §179(d)(1)(B).

25 I.R.C., §179(d)(2). The determination of "related taxpayers" is made through application of I.R.C., §§267 and 707(b), with the exception that for purposes of constructive ownership, the family of an individual shall not include his brothers and sisters, but only his spouse, ancestors and lineal descendants. Section 179(d)(2)(B) specifies that §179 property cannot be acquired by one member of an affiliated group from another member of the same affiliated group. Section 179(d)(2)(C)(i), which disqualifies property acquired with a "carryover" basis, will apply to contributions to a partnership by a partner as well as to typical gift situations. See I.R.C., §723.

26 See I.R.C., §267(b)(2). If Small Business himself were to purchase some property from Old Company, the property would not qualify for a §179 allowance in his favor.

27 I.R.C., §179(d)(1)(C).

tion of his income."[28] This interpretation of "useful life" has recently received judicial approval[29] and is likely to be applied to "section 179 property" as well. Even so, a very substantial amount of the cost of a qualified asset, as restricted by the ceiling, can be recaptured taxwise during its early life. Illustratively, if our entrepreneurs purchase *new* factory equipment at a cost of $10,000 intending to use it for six years, regular accelerated depreciation plus the effect of this new provision will enable them to take deductions against ordinary income of $4,667 during the first year.[30]

According to the foregoing, Small and Smaller Business would not be permitted to apply the new provision to any property which they plan to dispose of in less than six years. But if they reasonably expect at the time of purchase to use an item for the required period, section 179 would seem to be available without regard to any determination in a later year to dispose of the asset short of the six-year period. It is here that there exists what was perhaps an unintended, and what is an unwarranted, opportunity to convert ordinary income into capital gain. In the example given above, the 46 percent reduction in the basis of the equipment at the end of the first year would normally far outstrip any decline in the value of the asset. On the one hand, it is true that a sale of the property at its fair market value during the second year will, due to the lower adjusted basis, result in an increase in what otherwise would have been the realized gain. But this increased gain will fall under section 1231 and will be taxed, if at all, at capital gain rates. The existence of this opportunity for an additional benefit under section 179 argues for an interpretation of the six-year-useful-life requirement as one which relates to a particular taxpayer's anticipated period of use. It might even have justified, but did not, a downgrading to the status of ordinary income of that differential in gain which arises out of a combination of the additional first-year allowance and a premature sale.

Limitation by Way of a Ceiling. As previously indicated, the

28 Treas. Reg. §1.167(a)-1(b) (1956). (Emphasis added).

29 See Hertz Corp. v. United States, (D.C. Del. 1958) 165 F. Supp. 261.

30 Under I.R.C., §179(d)(8), the adjustment to basis as a result of a §179 deduction is to be made before any other depreciation deduction is taken. Thus the 20% allowance would reduce the basis of the $10,000 equipment to $8,000, against which the double-declining balance rate of 33⅓% can be applied to compute the entire allowance first-year depreciation.

congressional desire primarily to benefit small enterprises was reflected by the establishment of a ceiling on the total amount of acquisitions in any one year which could qualify for section 179 benefits. The additional 20 percent allowance may be taken on such property only to the extent of an aggregate cost in any one year of $10,000 per "taxpayer" or $20,000 in the case of husband and wife filing jointly.[31] The maximum deduction available will not, therefore, exceed $2,000 per taxpayer (or $4,000 in the case of the husband and wife filing jointly).

In addition, the "cost" of qualified property will not include that portion of its basis which is determined by reference to the basis of other property held at any time by the taxpayer.[32] If, for example, our new joint enterprise subsequently exchanges some of its section 179 property with Old Company, Inc., for property of "like kind," paying some boot, Old Company's acquisition would not qualify at all, and the new enterprise's acquisition would qualify only to the extent of the boot paid.[33]

In the event a taxpayer purchases qualified property in a given taxable year with a total cost in excess of the applicable section 179 limits, he is required to specify which items or fractions thereof are to be used for the additional 20 percent.[34] Since the taxpayer is allowed to allocate the cost, instead of being subjected to a mandatory rule geared, illustratively, to a LIFO concept, he is in a position to maximize his benefits. For example, if acquisitions during a taxpayer's first year included two $8,000 machines with useful lives of eight and ten years respectively, the taxpayer could maximize his deductions during the earlier years by applying the section 179 allowance against the full cost of the ten-year machine and against $2,000 of the cost of the eight-year machine. As depreciation allowances in subsequent years for longer-life property would always be less than for shorter-life assets with the same cost basis, maintaining a higher adjusted basis for the shorter-life property will provide the greatest amount of depreciation deductions in the immediately ensuing years.

Multiplication of Additional First-Year Allowances. It is

31 I.R.C., §179(b).

32 I.R.C., §179(d)(3).

33 See I.R.C., §1031(d) for rules relating to the basis of property acquired in a "like kind" exchange. The limitation in §179(d)(3) would also affect property acquired in a "trade-in."

34 I.R.C., §179(b). See H. Rep. 2198, 85th Cong., 2d sess., p. 13 (1958).

possible that our particular joint entrepreneurs would not have to make the choice involved in the last example cited above, for, depending upon the form in which they cast the enterprise and whether each files a joint return with his wife, they may be entitled to more than one full additional first-year allowance.

Since the ceiling fixed by section 179 relates to "the taxpayer,"[35] a typical corporate taxpayer would be entitled to only one maximum allowance per year. The Treasury Department has also indicated that such a limitation will be applied by it to the newly created section 1371 corporation even though the latter will not in fact suffer any tax—the current earnings of this entity being taxed directly to the shareholders.[36] Multiplication of the allowances is possible in the setting of a partnership, however, for it has been recognized that each partner is separately entitled, as "the taxpayer," to the section 179 allowance.[37] Thus if our joint entrepreneurs utilized the partnership form and each filed a joint return with his wife, four maximum allowances per year ($40,000 of property) would be available. In addition Old Company, of which Small Business is the sole stockholder, would enjoy a single allowance.[38]

History suggests that some businessmen will also attempt to multiply additional allowances through the use of somewhat artificial multiple entity arrangements. In the past, attempts by this means have been made to multiply the $25,000 exemption from corporate surtax or to divide income between the individuals and a corporate entity in order to stay in the more modest rate brackets applicable to each.

Probably it was awareness of this history that led the House Committee on Ways and Means to propose the $10,000 ceiling as a *single* limitation in any case in which a person controlled, was controlled by, or was under common control with, any other person or persons.[39] Since the term "persons" would have in-

[35] I.R.C., §179(b).

[36] See Instructions for the 1958 Form 1120-S, U.S. Small Business Corporation Return of Income. This view is open to some question. The government presumably rests on the fact that such a corporation, unlike a partnership, is not a perfect conduit.

[37] See Instructions for the 1958 Form 1065, U.S. Partnership Return of Income.

[38] While trusts may not utilize §179, the allowance is available to an estate, and the provision specifically authorizes an heir, legatee, or devisee separately to take an allowance with regard to any §179 property belonging to him and not held by the estate. I.R.C., §179(d)(5) and (6).

[39] See H.R. 13382, 85th Cong., 2d sess. (1958), which eventually became the Small Business Tax Revision Act of 1958, 72 Stat. 1676.

cluded corporations as well as individuals, that committee would have required apportionment of the single limitation if, illustratively, one person owned a proprietorship and controlled two corporations.[40] As the bill finally emerged from the Congress, however, apportionment of a single limitation was required only in the case of an "affiliated group" of includible corporations.[41] Accordingly, even if our joint entrepreneurs proposed to incorporate, it may be possible for them to multiply the number of allowances if each separately purchases up to $20,000 worth of qualifying property and leases that property to the corporation at a fair rental. By filing joint returns with their respective wives, the two entrepreneurs could each claim two allowances—a total of four—and the corporation would have its own separate allowance. Maneuvering souls who seek to so arrange their affairs should remember, because of the useful life requirement, that acquisitions will fall short of qualifying under section 179 if simultaneously accompanied by any intention to sell the property to the corporation within six years following enjoyment of the special deduction. Further prejudice could be incurred by such a transfer through loss of the benefits to be derived from the double declining balance method of depreciation. The corporation would not be a qualified "original" user.[42] However, in our particular setting the enterprise, if incorporated, would seem able to enjoy the special section 179 allowance on making the second-hand purchase, for it would not be a related taxpayer under the applicable "more-than-50-percent" control test.[43]

II. Form of Organization During Operational Phase

Historical Legislative Attitude Toward Form. The choice of a legal form in which to house an enterprise is generally determined by balancing the effect of a number of factors. The early attempts by Congress to neutralize the influence of the tax factor did not go beyond immunizing from tax the immediate

40 See H. Rep. 2198, 85th Cong., 2d sess., p. 15 (1958).

41 I.R.C., §179(d)(6), which treats all members of an affiliated group as one taxpayer for purposes of the additional first-year allowance.

42 Under Rev. Rul. 57-352, 1957-2 Cum. Bul. 150, the 150% declining balance method would be available to the corporation, however.

43 See I.R.C., §267(b)(2). If the property were donated to the corporation, the §179 allowance would not be available, due to the limitation in §179(d)(2)(C)(i) discussed in note 25 supra.

gain or loss which the judiciary held would otherwise be realized on the creation of or shift to certain forms. Provisions for nonrecognition of gain or loss on incorporation or on carrying out a corporate reorganization have been on the books, in one form or another, for forty years.[44] But wide gaps still remain in the statutory immunity sometimes provided on shifting from one form to another. Moreover, until 1954 much significance was attached by Congress to differences in form during the operational phase of an enterprise. The striking contrast between the historical tax treatment accorded the income of partnerships and corporations is well known. Equally well advertised are the resulting makeshift tax-dodging arrangements, such as the thin corporation and the business trust. These devices, and many others, were products of daring minds bent on obtaining the business advantage of a corporate entity while seeking to escape the so-called double tax.

In its wholesale revision of the code in 1954, Congress took occasion to re-examine the long-standing tax significance which it had attached to differences in form during the operational stage. Proposals were made which would have permitted corporations to elect to be taxed as partnerships,[45] and for proprietorships and partnerships to elect to be taxed as corporations.[46] However, only the latter opportunity, reflected in section 1361, survived congressional processing at that time. It was in the Technical Amendments Act of 1958, subchapter S, §§1371-1377,[47] that the mission was completed by taking account of the other side of the coin. Shareholders of a qualified "small business corporation" were finally granted an election to enable the enterprise to avoid the corporate tax.

The statutory label applied by section 1371 to a qualifying enterprise is somewhat misleading. "Small business corporation" refers not to dollar-size but to characteristics associated with its ownership. A qualified corporation, whether existing or new, can have no more than ten shareholders who may be either individuals or estates, and only one class of stock may be out-

[44] The original provision permitting nonrecognition of gain or loss in a corporate reorganization appears to have been §202(b) of the Revenue Act of 1918. The first provision permitting nonrecognition on incorporation was §202(c)(3) of the Revenue Act of 1921.

[45] S. Rep. 1622, 83d Cong., 2d sess., p. 452 (1954).

[46] S. Rep. 1622, 83d Cong., 2d sess., p. 455 (1954).

[47] 72 Stat. 1650 (1958). See note 12 supra and accompanying text.

standing.[48] Unlike the ill-fated proposal in 1954, the section 1371 corporation is not actually treated for tax purposes as a partnership, though the so-called double tax is avoided.

Thus, while small joint undertakings previously had a choice from among three legitimate tax forms (partnership, the section 1361 election to be treated as a corporation, and regular corporations), now there are four.[49] In order to convey some realistic impression of the tax significance of this new alternative, without purporting to tell the whole story, the discussion which follows compares its prime tax attributes with those of the other three during the phases which cover the operational life of Small and Smaller Business' *particular* joint undertaking. These phases include (1) organization and the initial loss years, (2) the period of expansion out of retained profits, and (3) the leveling-off period when maximum distributions will be made.

A. *Organization and the Initial Loss Period*

The Prime Concerns. When our joint entrepreneurs examine the tax implications which will be associated with that period encompassing organization and the initial anticipated loss years, concern will center on (1) obtaining maximum tax advantage of the anticipated losses, (2) the immediate income tax cost associated with the organization itself, (3) the degree of flexibility allowed in choosing an appropriate taxable year, and (4) possible opportunities to exclude desired fringe benefits from the individual gross incomes of the participants.

Significance of the Anticipated Initial Losses. Until recently, the recognized probability of initial operating losses would have left our entrepreneurs with an unhappy choice. On the one hand, any such probability was usually accompanied by a possibility that the enterprise might never actually reach a profitable stage. Thus Small Business, who has outside interests, would have preferred the comfort of limited liability associated with the corporate form. But traditionally, adoption of that form prevented him from taking immediate individual tax advantage of the anticipated operating losses by offsetting it against his outside business income.

[48] I.R.C., §1371(a). See Proposed Treas. Reg. §1.1371-1 (1959), for a detailed explanation of the qualifications for subchapter S benefits.

[49] For commentary on new subchapter S prior to issuance of the proposed regulations, see generally, Anthoine, "Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment," 58 COL. L. REV. 1146 (1958); 23 ST. JOHN'S L. REV. 187 (1958); note, 72 HARV. L. REV. 719 (1959); symposium, 10 J. OF TAXATION 130 (1959).

Formerly, this tax advantage was achieved only in the partnership setting, at the expense of losing the opportunity to obtain limited liability.

The fact that a new corporation would enjoy a five-year carry-over of the operating loss became less satisfying as a solution when account was taken of the possibility that the enterprise might never reach a profitable stage. In addition, there was always present the bird-in-hand philosophy which leads taxpayers not to put off until tomorrow a tax advantage which could be enjoyed today. Now, however, the competing character of Mr. Small Business' concerns has been eliminated. Incorporation plus a subchapter S election would provide him with limited liability as well as the opportunity to obtain immediate tax advantage of the operating losses suffered by the enterprise.[50] Aside from the fact that such losses cannot be carried back to a period prior to January 1, 1958,[51] there is only one important limitation on the net operating loss pass-through enjoyed by shareholders of a section 1371 corporation. Each stockholder's portion of the loss may not exceed and, of course, serves to reduce, the adjusted basis of his stock plus any corporate indebtedness to him.[52] Thus, if initial losses unexpectedly threaten to wipe out the stockholders' interest, additional loans or capital contributions contemplated by shareholders should be made, if at all, within the loss year in order to obtain a pass-through of the full operating loss.[53] Otherwise, the excess loss will not be carried over by the corporation for a subsequent pass-through.[54]

While the pass-through enables the shareholder to take advantage of the loss in his taxable year in which or with which the corporation's taxable year ends,[55] in order to accommodate possible

50 I.R.C., §1374. To the effect that the salary received by a corporate officer is business income for purposes of computing a net operating loss, see Folker v. Johnson, (2d Cir. 1956) 230 F. (2d) 906.

51 I.R.C., §1374(d)(2).

52 I.R.C., §§1374(c)(2) and 1376(b).

53 I.R.C., §1374(c)(2) states that the net operating loss pass-through is limited to the adjusted basis of the shareholder's interests, determined as of the close of the corporation's taxable year or as of the day before any sale or disposition of the stock by the shareholder.

54 While a partner's distributive share of partnership loss is allowed to the extent of the basis of his partnership interest, any excess loss is not wasted. It is allowed as a deduction whenever the basis of the partner's interest is subsequently increased. See I.R.C., §704(d).

55 I.R.C., §1374. Since the net operating loss is allowed as a deduction from the gross income of a shareholder for his taxable year in which or with which the taxable year

mid-year changes in stock ownership, the loss—computed on a yearly basis—is apportioned among consecutive stockholders on a daily basis, i.e., by reference to the respective percentage of the year in which consecutive stockholders owned the shares.[56]

Comparison of Immediate Tax Costs Associated With Organization. The act of organizing an enterprise creates two income tax problems. One concerns the tax treatment of organizational expenses; the other relates to the tax cost associated with any contributions of property which may be made by participants. On these counts, too, the new section 1371 arrangement would prove to be an advantageous arrangement.

Until 1954, the organizational expenses of a typical corporation had to be capitalized. Such meager authority as existed called for the same result in connection with the formation of partnerships.[57] Then in 1954 provision was made authorizing a corporation, but not a partnership, to amortize such expenses over a period of not less than sixty months.[58] This provision, however, did not wholly satisfy the problem of a corporation which initially anticipated operating losses, for the election was available only if the corporation commenced amortization with the month in which it began business.[59] The effect of the election, if our joint undertaking assumed regular corporate tax status, would be to increase the anticipated operating loss, the only benefit from which would be the possibility of utilizing a loss carryover. Now, however, that election is also available though the corporation takes on the immunizing cloak of section 1371,[60] and the increased loss can be passed through to the shareholders for use as an offset against their personal incomes.

In one respect, section 1371 is also as advantageous as any other arrangement with regard to the immediate tax cost associated with capital contributions of property. If Small Business contemplates, as a part of his capital contribution, the transfer of a building worth more than its basis, the increment in value will

of the corporation ends, it is clear that if a shareholder dies before the end of the corporation's taxable year, his pro rata share of the corporation's net operating loss for that year will not be deductible by anyone. See Proposed Treas. Reg. §1.1374-1(b)(2) (1959).

56 I.R.C., §1374(c)(1).

57 Abe Wolkowitz, 8 T.C.M. 754, 1949 P-H T.C. Memo. Dec. ¶49,212. See Meldrum & Fewsmith, Inc., 20 T.C. 790 (1953), affd. on other grounds (6th Cir. 1956) 230 F. (2d) 283.

58 I.R.C., §248.

59 I.R.C., §248(a).

60 I.R.C., §1373(d)(2).

not be recognized as taxable gain to him.[61] Nonrecognition is also available where a proprietorship or partnership invokes corporate tax status under section 1361, but only if the election is made in the *first* taxable year of the joint undertaking.[62] This first-year limitation is not involved, however, when shareholders of a true corporation elect to enjoy subchapter S status.

In connection with another facet of the foregoing problem, the partnership setting still holds an edge. In the absence of boot, the old basis of the contributed property carries over in the hands of each form of enterprise. With regard to depreciation on this property, the enterprise will not enjoy a deduction commensurate with the value assigned to the property for contribution purposes, thus indirectly prejudicing any participant who contributed cash. To remedy this difficulty, the partnership provisions specifically allow the partners to agree to a compensating division of the taxable income of the enterprise.[63] In effect, arrangements can be made whereby the former owner of the contributed property will include in his own distributive share of profits that portion of the firm's taxable income which arises solely because of the lower depreciation deduction. In the case of the particular joint undertaking of Small and Smaller Business, the depressed deduction will initially mean that the operating loss for tax purposes will be less than it would be if depreciation had been computed on the basis of contributed value. Accordingly, any contractual agreement between them should provide that Smaller Business, the contributor of cash, would enjoy the advantage of a larger share of the operating loss than would otherwise be the case.

The simple contractual adjustment which is possible to accommodate the foregoing problem in the partnership setting seems not to be available under a section 1371 arrangement. There the pass-throughs are determined solely by reference to the portion of stock held.[64]

Flexibility in Choosing an Appropriate Taxable Year. It has never been necessary for a regular corporation to utilize the same taxable year as that of its shareholders. Any differences which may

[61] This would be true assuming the transfer came within the terms of I.R.C., §351.

[62] I.R.C., §1361(m)(2) and Proposed Treas. Reg. §1.1361-12(c) (1959).

[63] I.R.C., §704(c)(2).

[64] I.R.C., §1374(c)(1). Any attempt at an equitable adjustment of shareholders' interests with regard to this problem through the issuance of two classes of stock would prevent the corporation from qualifying for subchapter S treatment.

exist, however, are not as significant taxwise as are like differences in a partnership setting. Dividends and the salaries of stockholders who are also officers are includible by typical cash basis shareholders when received, without regard to differences in the corporate and individual taxable years. On the other hand, a partner's distributive share of a firm's income or loss is reflected in his individual return for the taxable year in which the firm's taxable year ends.[65] Because it was possible under this principle, through manipulation of taxable years, to achieve as much as an 11-month deferral of tax, Congress was led to require that a partnership adopt the taxable year of all its principal partners unless it established a business purpose for doing otherwise.[66] But because this principle was not applied to a corporation, one which has elected to come under section 1371 enjoys a slight advantage over a partnership in choosing its taxable year. The taxable year of a section 1371 corporation can be so fixed that, except with reference to salaries paid officer-stockholders, an eleven-month deferral of tax on the income of the enterprise can be achieved. While dividends which are distributed in that setting are taxable to cash basis stockholders when received,[67] withholding such distributions means that the undistributed taxable income of the section 1371 corporation will be taxed to the stockholders only in their taxable year with or within which the corporation's year ends.[68] This latter notion also applies to the pass-through of operating losses.

Thus, any rigging of taxable years to achieve deferral of tax in good years will mean that during the earlier anticipated loss years the pass-through will also be reflected on a delayed basis. If much rigging of this type takes place in the section 1371 setting, it can be hoped that Congress will apply the same remedy it eventually resorted to in the partnership setting.[69]

65 I.R.C., §§702 and 706(a).

66 I.R.C., §706(b)(1).

67 Cash distributions out of earnings and profits of a §1371 corporation are governed in general by the usual rules of §301 and §316. See Proposed Treas. Reg. §§1.1372-1(c)(2) and 1.1373-1(f) and (g) (1959).

68 I.R.C., §1373(b). I.R.C., §1373(c) defines "undistributed taxable income" as taxable income less cash distributions as dividends out of current earnings and profits during the taxable year. I.R.C., §1373(d) states that the "taxable income" of a §1371 corporation shall be determined without regard to the net operating loss deduction, the 85% domestic corporation dividends-received deduction and certain other special corporate deductions.

69 Proposed Treas. Reg. §1.442-1(b) (1959), indicates that approval for a change in the annual accounting period of a §1371 corporation will ordinarily be denied if the

Fringe Benefits. Depending on the nature and size of the business operation, participants who are to be active may desire to avail themselves of the tax advantages associated with certain fringe benefits which are excludable by "employees." Again, a section 1371 arrangement has an advantage over partnership arrangements.

In the case of a motel or restaurant, section 119 allows an exclusion under certain circumstances for meals and lodging furnished employees. While it is generally conceded that a partner cannot be an "employee,"[70] the question whether this particular benefit is available to a partner under another heading is still open to some doubt.[71] But other advantages, such as the exclusion of sick pay, of contributions made by an employer toward employee accident and health insurance policies, and of employee death benefits would clearly seem beyond a partner's reach.[72]

All of these advantages would be available, of course, in the setting of a regular corporation, and would also be available if, as a partnership, the entrepreneurs elected corporate tax status under section 1361. But under either of these forms, the pass-through of the anticipated initial operating loss would be lost. Moreover, there is one fringe benefit which is not available in the section 1361 setting—that relating to the various deferred compensation arrangements governed by section 401.[73] But that benefit, as well as all of the others, would be available in a section 1371 setting, and there the desired pass-through of initial operating losses will also take place.

B. *Period of Expansion out of Retained Profits*

In General. Once the enterprise becomes profitable, it is contemplated that for a number of years the earnings will be retained to facilitate expansion.

Assuming that the two entrepreneurs plan to begin their joint undertaking as a partnership or in a section 1371 setting in order

effect would be to shift or defer income or pass through a long-term capital gain or a net operating loss. But declaration of a "short" taxable year by a newly-created §1371 corporation in order to insure a maximum loss pass-through for that year is possible.

[70] See, e.g., Estate of S.U. Tilton, 8 B.T.A. 914 (1927).

[71] Compare George A. Papineau, 16 T.C. 130 (1951) (nonacq.) with Commissioner v. Doak, (4th Cir. 1956) 234 F. (2d) 704. See also Rev. Rul. 80, 1953-1 Cum. Bul. 62.

[72] See Rev. Rul. 56-326, 1956-2 Cum. Bul. 100.

[73] I.R.C., §1361(d).

to obtain a pass-through of the initial anticipated losses, a switch in form may be desirable whenever the earnings after salaries reach the level where the corporate tax would be less than the tax which such earnings would suffer when pyramided on top of the salaries and other income of Small and Smaller Business. Since the earnings will be retained to accommodate reasonable business needs, there will be no likelihood of an immediate double tax even though the shift is to regular corporate tax status. Dividends are not contemplated, and the section 531 penalty tax will be inapplicable either through reliance on the minimum credit or because of the nature of the immediate plan to expand.

Shifting From a Partnership to Corporate Tax Status. If our joint entrepreneurs choose initially to operate as a partnership, two courses of action will be open to them at the point when the corporate rate becomes attractive: invocation of the section 1361 election to be taxed as a corporation, or outright incorporation.

As a two-man partnership in which capital is a material income-producing factor, the firm would qualify for the section 1361 election.[74] While this provision might appear to be the likely alternative for the purpose under consideration, a host of uncertainties regarding its meaning in various contexts and two prime shortcomings make any such election highly questionable. The election is irrevocable, except in the case of a 20 percent change in ownership.[75] Consequently, it may not be possible to revert to partnership status at a later point when the enterprise has reached the leveling off stage and the bulk of the then current profits are to be distributed annually. Nor at that later point could the so-called double tax be avoided by an election to come under section 1371. According to the Treasury Department, irrevocability of the section 1361 election means, inter alia, that later use of section 1371 is precluded unless the section 1361 enterprise first goes through an actual incorporation,[76] which might require a costly liquidation in kind of the section 1361 arrangement.[77] The foregoing reasons suggest that federal tax

74 I.R.C., §1361(b).

75 I.R.C., §1361(e) and (f). While a §1361 election may be revoked until within three months after final regulations are issued [§63, Technical Amendments Act of 1958, 72 Stat. 1649] this will not be of benefit to a corporation which subsequently discovers that a §1361 election was unwise, and that it should in fact have been operating as a regular corporation during the time of its election.

76 See Proposed Treas. Reg. §1.1361-3(a)(3) (1959).

77 See Proposed Treas. Reg. §§1.1361-5(b) and 1.1361-11 (1959).

considerations point to actual incorporation at that point when profits are to be retained for expansion.

The shift from a partnership form to an actual corporation is usually accomplished in one of three different ways: (1) a direct transfer of assets by the partnership to the new corporation in return for stock, (2) a liquidation of the partnership followed by a transfer of assets to the corporation by the individual partners themselves, or (3) a transfer by the partners of their partnership interests in return for stock.[78] Generally each may be accomplished without tax incidence.[79] Any accelerated depreciation benefits currently enjoyed by the partnership will be lost, however, when the firm's assets are transferred to the corporation. It will not be an "original" user.[80] Moreover, the section 179 additional first-year depreciation allowance will not be available to the corporation for any property acquired from the partnership, because of a carryover of the basis of such property.[81]

The transition may also serve to bunch more than one year's income into a single taxable year of the partners unless the incorporation is accomplished as of the close of the regular partnership year. Where it does not seem desirable to postpone incorporation to such date, then for the foregoing reason and also because potential deductions may be lost, it may be necessary to keep the partnership in existence for a limited time after incorporation, some of its property being rented to the corporation in the interim.

Shifting From a Section 1371 Arrangement to Regular Corporate Tax Status. One of the most significant features of the new subchapter S provisions is that the election to avoid the corporate tax may be voluntarily revoked without immediate tax cost, through the consent of all shareholders. In some instances it may also be automatically terminated.[82] In either case, another election cannot be made without the government's consent until after the expiration of five years, beginning with the first year in which the revocation or termination was effective.[83]

78 See, generally, Clapp, "When Is It Desirable Taxwise To Incorporate a Partnership?" TENTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 1107 (1952); Friedman and Silbert, "Transferring Partnership Assets to a Corporation," TENTH ANNUAL N.Y. UNIV. INST. ON FEDERAL TAXATION 1085 (1952).

79 This will be true under I.R.C., §351.

80 See I.R.C., §167(c)(2).

81 I.R.C., §179(d)(2)(C)(i).

82 I.R.C., §1372(e).

83 I.R.C., §1372(f).

If our joint undertaking began life as a section 1371 corporation, the two entrepreneurs have the power to revoke the election at any time after the first taxable year it has been in force, thereby shifting the enterprise to regular corporate tax status.[84] It is important to realize, however, that a revocation is effective for the taxable year in which it is made only if made within the first month of that taxable year.[85] Otherwise it is effective only for succeeding years.[86]

An automatic termination of the subchapter S election will result if any new shareholder does not consent to the election[87] or the corporation ceases to qualify as a section 1371 corporation.[88] In either case, the termination will be effective as of the taxable year in which the disqualification occurs. Literally interpreted, this would mean that the two shareholders of our section 1371 corporation could delay their decision as to a change in form until near the end of a particular taxable year without depriving themselves of a shift to regular corporate tax status for that year. A termination late in the year might be accomplished through deposit of a few shares of stock in trust or issuance of a second class of stock, as well as through a transfer of a few shares to a non-consenting stockholder. While all three of these serve to disqualify a corporation and would literally cause a termination beginning with *that* taxable year, it seems unlikely that Congress actually contemplated this sort of "wait-and-see" operation. Success on employing such tactics would render meaningless the previously described restrictions regarding revocation. It may be that a "bona fide transfer," contemplating something in the nature of a business purpose requirement, will be invoked when an attempt is made in this manner to avoid the restrictions regarding revocation. The proposed regulations, however, do not go beyond referring to the need for a "bona fide transfer" for purposes of determining which shareholders must include undistributed taxable income in their gross incomes at the end of the taxable year.[89]

If it was originally contemplated for the first stage—the an-

84 I.R.C., §1372(e)(2).
85 I.R.C., §1372(e)(2)(A).
86 I.R.C., §1372(e)(2)(B).
87 I.R.C., §1372(e)(1).
88 I.R.C., §1372(e)(3).
89 Proposed Treas. Reg. §1.1373-1(a)(2) (1959).

ticipated loss period—that our joint undertaking would be launched as a section 1371 corporation, care should be taken at the outset to guard against an *unexpected* automatic termination. For example, the nature and source of income of a section 1371 corporation may affect the duration of the election. A termination results whenever the corporation derives more than 80 percent of its gross receipts from foreign sources,[90] or more than 20 percent of its gross receipts from royalties, rents, dividends, interest, annuities, and gains on the sale or exchange of stock or securities.[91]

While it is not likely that our particular undertaking would be affected by the foregoing possibilities, it is possible that one of the shareholders might force a termination of the election through a deliberate transfer of his shares in trust or to a non-consenting shareholder. For example, as the enterprise moved into the black, it is entirely possible that, because of Small Business' larger outside income, he would prefer a shift to corporate tax status before the corporate rate became attractive to Smaller Business. In any event, shareholders who are prepared to consent initially to a subchapter S election may well consider the desirability of some kind of escrow arrangement in order to see that one uninformed or cantankerous stockholder does not later force what to others would be a premature ditching of the election. One proposed Treasury concession would afford relief in some situations of this type. Recognizing that dissatisfied minority shareholders might force a termination through deliberate transfers in trust or to a non-consenting shareholder, the proposed regulations have provided that consent to resume the election without the otherwise required five-year wait may be obtained if the event causing the termination was not reasonably within the control of the corporation or shareholders having a "substantial interest" in the corporation, and was not part of a plan in which these shareholders participated.[92]

Inasmuch as our two shareholders plan to expand operations once the enterprise begins to realize profits, the required "break" of five years between revocation and re-invocation of section 1371

[90] I.R.C., §1372(e)(4).

[91] I.R.C., §1372(e)(5). The proposed regulations indicate that the term "rents" will not generally include payments for the use or occupancy of rooms in a hotel, boarding house, apartment house furnishing hotel services, or a motel. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments. Proposed Treas. Reg. §1.1372-4(b)(5)(iv) (1959).

[92] Proposed Treas. Reg. §1.1372-5(a) (1959).

status will be of concern only if the corporation accumulates over $100,000 and completes its expansion plans before the expiration of the five-year period.

If the new $100,000 minimum credit for accumulations[93] is eventually reached and there are no further business reasons for accumulating earnings and profits, fear of the possible invocation of the section 531 penalty tax will render regular corporate tax status undesirable. At that point consideration must be given by our entrepreneurs to the methods by which the so-called double tax can be avoided.

C. *The Leveling-Off Period Accompanied by Substantial Distributions*

Prime Alternatives To Avoid the Double Tax. During the preceding period, corporate tax status provided a shelter which permitted rapid growth out of earnings and profits. After that stage of operation has been completed and maximum distributions are to be made from current earnings, avoidance of the so-called double tax on corporate profits can be attained in different ways, depending in part on the method which was used earlier to attain regular corporate tax status.

If corporate status was accomplished through regular incorporation, a subchapter S election or liquidation and subsequent operation as a partnership provide alternative escape routes.

Normally the election route would be preferred, for a liquidation in kind to the original stockholders of a previously profitable corporation which has accumulated substantial earnings and profits can be a very costly process to them, income-tax-wise. Indeed, as previously noted, it was partly because that same cost could not be avoided in shifting away from corporate tax status attained by a section 1361 *election* that our entrepreneurs would have preferred *regular* incorporation during the expansion period, avoidance of the corporate tax during the succeeding period of distributions to be accomplished by a subchapter S election which can be made with tax immunity.

The intricacies of new subchapter S in a setting where distributions will be made make it essential, however, that corporations inclined toward its use pay close attention to the way the new provisions treat (1) ordinary cash dividends and undis-

[93] I.R.C., §535(c)(2).

tributed taxable income of the first year under the election, (2) delayed distributions of undistributed taxable income, (3) the personal nature of the "undistributed-taxable-income" concept, (4) distributions in kind, and (5) items which, because of their peculiar complexion, are endowed with unusual tax characteristics when received by a regular corporation.

Treatment of Ordinary Cash Dividends and Undistributed Taxable Income of the First Year Under the Election. While a section 1371 corporation is immune from tax with respect to its "taxable income," a shareholder includes in his gross income the full amount of "dividends" *received* during his taxable year.[94] In addition, in his individual taxable year with or within which the corporation's taxable year ends, he must include his pro-rata share of the corporation's "undistributed taxable income."[95] This inclusion may or may not coincide with the year in which he included the dividends actually received.

Here, as in the setting of a corporation which has not made the election, the question whether a cash distribution is a "dividend" will be first determined by reference to whether there are *current* "earnings and profits" out of which a dividend could be paid. This determination is made as of the *close* of the corporation's year.[96] Assuming that an amount of "money" equal to 75 percent of the current earnings and profits was distributed, that amount will be subtracted from the corporation's "taxable income" for the same period in determining the "undistributed taxable income" which also must be included in the shareholder's return at the point of time previously indicated.[97]

In his hands, neither of the foregoing amounts would normally enjoy the benefit of the dividends-received exclusion or the dividends-received credit.[98] After all, those immunizing principles were created only for the purpose of cushioning the impact of the so-called double tax in the regular corporate setting.

94 See note 67 supra.

95 See note 68 supra.

96 See Proposed Treas. Reg. §1.1373-1(d) (1959) and I.R.C., §316(a).

97 I.R.C., §1373(c).

98 I.R.C., §1375(b), which denies the benefit of the exclusion and credit to the amount includible in the gross income of a shareholder as "dividends," to the extent that such amount is a distribution out of current earnings and profits. For purposes of this subsection, however, current earnings and profits may not exceed the corporation's taxable income for the taxable year. Thus, any distributions out of current earnings and profits in excess of taxable income will enjoy these benefits. See note 137 infra and accompanying text.

Here, to the extent the distributions are from current earnings, the possibility of a double tax is avoided through the immunity enjoyed by the corporation. *Excess* distributions which in this first year would necessarily come out of earnings and profits accumulated before the election are, however, considered regular dividends and will qualify for the exclusion and the credit.[99]

Subsequent Distributions of Prior Undistributed Taxable Income. Since "undistributed taxable income" is required to be included in the gross incomes of the shareholders, the complementary effects on them should and do correspond at least roughly to those which follow two related situations, (a) where a dividend is actually received in a section 1371 setting and is then re-invested in the business as a capital contribution,[100] and (b) where a partner includes in his return his distributive but undistributed share of partnership income. First, in all such cases, the basis of the individual's interest, here stock, should be increased by a like amount.[101] Second, since the "undistributed taxable income" was taxed to the stockholders as currently earned, subsequent distribution in a later year of a stockholder's net share of what then would be *prior* undistributed taxable income should not be treated as a taxable dividend.[102] Instead, as in the partnership setting, the distribution should reduce the basis of his stock.[103]

At the corporate level, while the company's current taxable income increases its earnings and profits, the latter must be reduced by the amount of cash dividends paid,[104] and at the end of that corporate year by the amount of undistributed taxable income included in the shareholder's gross.[105] Subsequent non-dividend distributions attributable to *prior* undistributed taxable income will not again reduce the corporation's accumulated earnings and profits.[106]

A question may arise as to the method of determining whe-

99 See Proposed Treas. Reg. §1.1375-2(a) and (b)(2) (1959).

100 See Proposed Treas. Reg. §1.1376-1 (1959).

101 I.R.C., §1376(a).

102 I.R.C., §1375(d).

103 Since a distribution of this type is considered a distribution "which is not a dividend," the basis of the shareholders' stock would be reduced under I.R.C., §301(c)(2). See Proposed Treas. Reg. §1.1372-1(c)(2) (1959).

104 See I.R.C., §312(a) and Proposed Treas. Reg. §1.1372-1(c)(6) (1959).

105 I.R.C., §1377(a).

106 I.R.C., §1375(d)(1).

ther a delayed distribution should first be assigned to prior "undistributed taxable income" or to "accumulated earnings and profits." For example, if the corporation formed by our two stockholders made the subchapter S election after it had accumulated $100,000 and then $10,000 of *undistributed* taxable income was included in the shareholders' gross incomes in the first election year, would a distribution in the second year in *excess* of second year earnings be allocated to the prior "undistributed taxable income," and be received tax free? Or would the excess distribution be allocated first to the "earnings and profits" accumulated prior to the election, in which case the excess distribution would be taxable as a regular dividend?

Generally speaking, the proposed regulations suggest the application of a rule, the most typical effect of which resembles that reached under LIFO in inventory accounting. Actual distributions of cash in excess of current earnings are to be treated as a distribution of prior undistributed taxable income to the extent of the stockholder's net share of such income immediately before the distribution.[107] However, with the consent of all shareholders, a corporation may elect instead to treat the accumulated earnings and profits as the source of the distribution rather than the previously taxed but undistributed income.[108]

It is also important that shareholders realize that a subsequent distribution of previously taxed income will be tax-free only to the extent of the shareholder's *"net share"* of prior undistributed taxable income.[109] Obviously, the computation of the *net* share contemplates that *intervening* "non-dividend" distributions will be subtracted from undistributed amounts previously included in his gross income in order to determine the amount currently available for tax-free distribution.[110] But for the same purpose, by statutory definition that "net" must also be reduced by net operating losses which were allowable as a deduction to the shareholder for *any* election year *prior* to the delayed distribution now in question.[111]

107 Proposed Treas. Reg. §1.1375-4(b) (1959).

108 Proposed Treas. Reg. §1.1375-4(c) (1959).

109 I.R.C., §1375(d)(1).

110 I.R.C., §1375(d)(2)(B)(ii).

111 I.R.C., §1375(d)(2)(B)(i). The proposed regulations state that prior net operating loss deductions will reduce the shareholder's net share of prior undistributed taxable income whether or not claimed on the shareholder's tax return and whether or not resulting in any tax benefit. See Proposed Treas. Reg. §1.1375-4(d) (1959). In the case of

This second "net share" limitation becomes significant when a corporation with both accumulated earnings and profits and prior undistributed taxable income experiences a loss year. If a distribution of *prior* undistributed taxable income is made *during* the loss year, the distribution will be tax free. But if the distribution is not made until *after* the close of the loss year, the amount of the net operating loss for that year which is allowable as a deduction to the shareholders will reduce the amount of the distribution which can be made tax-free. The excess distribution over the "net share" of prior undistributed taxable income will be taxable as a regular dividend out of accumulated earnings and profits.

Planning-wise, it is significant that the required reduction in prior undistributed taxable income relates only to net operating losses of a *prior* year. When a corporation, having both accumulated earnings and prior undistributed taxable income finds itself in the midst of what is likely to be a loss year, it would do well by its shareholders to distribute, if practicable, the prior undistributed taxable income before the close of that loss year. But resort to such careful timing will not have long range significance unless the shareholders recognize the necessity of withdrawing as much as possible of subsequent years' earnings during the years earned. Otherwise the earlier loss allowable as a deduction to the shareholders at the close of the loss year will also reduce the amount of *subsequent* undistributed taxable income which can be distributed tax free on a delayed basis in later years.

One example will indicate the practical reasons which justify the foregoing. Suppose that the shareholders of a corporation with accumulated earnings and profits of $100,000 on January 1, 1959 filed an election to have the enterprise treated as a section 1371 corporation beginning with that year. During 1959 it enjoyed current earnings and taxable income of $60,000 which, though *not* distributed, was passed through and taxed to the shareholders. Inclusion of this amount by them served to wipe out the corporation's current earnings account, but did not affect its earlier accumulated earnings account. A resumption of

a corporation operating under its second subchapter S election, a shareholder's net share of prior undistributed taxable income is determined solely by reference to taxable years subject to the new election. See Proposed Treas. Reg. §1.1375-4(d) (1959).

periodic distributions took place on March 1, 1960, when $15,000 was distributed. Perhaps it was supposed that this would actually be accommodated out of anticipated earnings and profits of the current year, 1960. But at the point of distribution, the management will *not actually* know the precise outcome of operations for that year. And as events turned out, the corporation experienced an operating loss of $50,000. The *surprised* shareholders will not be entrapped, for the distribution of $15,000, having been made *during* the loss year, will still be tax free, the assumption being made now that it came from the previously taxed undistributed taxable income account.[112] And the $50,000 loss will be passed through as a deduction which the shareholders can take against other income. But any attempt in the following year, 1961, to distribute an amount of $45,000 in excess of that year's earnings to the *now forewarned* stockholders will result in a dividend. It will be recalled that the 1960 loss of $50,000 which was passed through to them did not affect the accumulated earnings account. But as of January 1, 1961, it was appropriate to net the passed through loss against the previously passed through undistributed taxable income account of $45,000.[113] Thus, as of that date, at the corporate level, only accumulated earnings and profits remained as a source for the excess distribution in 1961 of $45,000 over that year's earnings.

There is one other situation where the timely extraction of prior undistributed taxable income may provide a significant advantage. If that account remains undistributed as of the effective date of a revocation or termination of the subchapter S election, the undistributed taxable income will lose its special character even though it was once taxed to the shareholders.[114] The fund apparently remains in the corporation as a contribution to capital which cannot be withdrawn tax-free until all current and accumulated earnings and profits are distributed, even if the election is resumed.[115] Thus, it may be desirable for

112 It is true, however, that the benefit of a tax-free distribution of prior undistributed taxable income *during* the loss year will be available even if the shareholders anticipated the loss at the time of the distribution and merely acted to obtain this benefit.

113 Where both accumulated earnings and profits and undistributed taxable income exist, it seems reasonable that a net operating loss should be charged against the latter for both are certain to reflect activity of election years.

114 But since this income was previously taxed to the shareholders, the basis of their stock has been correspondingly increased. I.R.C., §1376(a).

115 See Proposed Treas. Reg. §1.1375-4(a) (1959).

a section 1371 corporation contemplating revocation or termination to distribute all such income before its election ceases.

Significance of the "Personal Nature" of Undistributed Taxable Income. A corporation's retention of undistributed taxable income will normally increase the value of its outstanding shares. Since the periodic inclusion by a stockholder of his net share of that undistributed income served immediately to increase the basis of his stock, however, the reflected increment in value will not again be taxed to him as capital gain should he sell his interest before the previously taxed fund is distributed to him. But then the question arises, will the purchaser acquire the same potential immunity from tax which the original shareholder could have enjoyed with reference to distributions from the prior undistributed taxable income account?

The literal language of the statutory provision in which Congress dealt with delayed distributions of prior undistributed taxable income would, if it stood alone, call for a negative answer.[116] There Congress expressly made those rights personal to the particular stockholder who had previously included the undistributed taxable income in his own gross income. However, the literal language of that provision does not seem to provide the whole answer. And as a consequence, the concept reflected in that provision assumes *practical* significance only in the instance where the corporation has accumulated earnings and profits as well as a previously taxed undistributed taxable income account.

Where it has *only* the latter, as will frequently be true where an election was made under section 1371 immediately upon incorporation, a distribution to the purchaser in an amount in excess of that distribution year's taxable income could not be a taxable dividend to the extent of that excess. A combination of two other rules brings about this result. It must be remembered in the first instance that while a corporation's "taxable income" increases its accumulated earnings and profits, the latter account is reduced by dividends and at the close of each year by the undistributed taxable income of that year.[117] The net effect of this is

[116] I.R.C., §1375(d)(1). Only if the seller himself again becomes a shareholder while the corporation is subject to the same election can the benefits of the previously taxed fund be enjoyed. A sale of only part of his stock, however, would not reduce the seller's share of prior undistributed taxable income. See Proposed Treas. Reg. §1.1375-4(e) (1959).

[117] See text accompanying note 105 supra.

to say that a corporation which has *only* a prior undistributed taxable income account does not thereby also have an accumulated earnings and profits account. Therefore, since a distribution, by definition, cannot be a taxable dividend under section 316 unless there are earnings and profits out of which such could be paid, the delayed distribution now under consideration would not be taxable to the purchaser. It would simply serve, according to section 301, to reduce the basis of his stock.

Thus, where the corporation has accumulated as well as current earnings and profits, the overall effect is that the purchaser will be required to follow what in more typical settings would be the practical equivalent of the FIFO rule in inventory accounting. To the extent such earnings and profits exist, distributions to him will be taxable. This is similar to a FIFO arrangement only in the practical sense that accumulated earnings and profits of a section 1371 corporation will normally be traceable back to pre-election years.

Another more serious problem associated with sales involves those made in mid-year. Since undistributed taxable income is includible only by those who are shareholders on the last day of the corporation's taxable year,[118] a sale during the year will have the effect of thrusting on the purchaser the full tax liability for that taxable year's undistributed taxable income. Interesting problems thus arise which will affect the determination of a fair price for stock in a section 1371 corporation. And in this connection, consideration must also be given in some cases to the fact that the net operating loss pass-through is apportioned to the shareholders on a daily ownership basis.[119] The price, in the case of a mid-year sale of stock at a point when the corporation appears to be suffering a loss, should take account of the fact that the seller, not the buyer, will enjoy the tax benefit associated with that portion of any loss which, at the end of the year, will be apportioned back to that part of the year preceding the sale. But account must also be taken of the possibility that earnings for the remainder of the year may wipe out the earlier loss, in which case the seller is deprived of his anticipated tax benefit. It has, perhaps unexpectedly, shifted to the buyer, for the earnings

[118] I.R.C., §1373(b).
[119] I.R.C., §1374(c)(1).

covering his period as a shareholder will be offset, dollar for dollar, by the pre-sale loss.[120]

Distributions in Kind in a Section 1371 Setting. As is true in a regular corporate setting, distributions of property in kind may constitute a dividend.[121] However, because of the combined effect of three rules, a marked difference in tax consequence can result depending on whether the corporation has accumulated earnings and profits in addition to the profits of the current year. If it does, it may be less costly to distribute a cash dividend equal in amount to the fair market value of the property which would otherwise be distributed.

The three rules which, when combined, may bring about the difference in tax consequence are (1) only distributions of *money* reduce "undistributed taxable income" of the current year,[122] (2) any undistributed taxable income is passed through and actually taxed to the shareholder only to the extent of the earnings and profits,[123] and (3) the distribution in kind is taxable only to the extent earnings and profits are available to accommodate its fair market value.[124]

Suppose first that a corporation without accumulated earnings and profits as of the first of the year correctly contemplated current earnings would amount to $30,000, and that in midyear it distributed an asset having a basis of $20,000 and a fair market value of $30,000. The distribution in kind constituted a dividend to the extent its fair market value, $30,000, could be accommodated out of earnings and profits. But that distribution did not reduce "undistributed taxable income" ($30,000) which, to the extent of available earnings and profits, is to be passed through. Thus, if it be assumed that the distribution in kind did not itself constitute a realization by the corporation of the appreciation in the value of the asset,[125] the first question

120 An additional problem with regard to the sale of stock in a §1371 corporation is the fact that a non-consenting shareholder can terminate the election. Shareholders may seek protection against such a situation through provisions giving the corporation or other shareholders the first right to purchase the stock.

121 While distributions in kind may raise problems with regard to collapsible corporations, the effect of subchapter S on such corporations is considered only briefly infra. A detailed study of the relationship between subchapter S and collapsible corporations is beyond the scope of this article.

122 I.R.C., §1373(c).

123 I.R.C., §1373(b) and 316(a).

124 I.R.C., §301(c)(1).

125 See I.R.C., §311.

concerns the manner in which the current earnings and profits ($30,000) will be assigned to the two different items.

Where there are no cash distributions, the proposed regulations seek to compensate for a statutory deficiency by providing that the current earnings and profits will be allocated ratably to the two different $30,000 items, the ratable share of the distribution in kind to take into account its fair market value.[126] Thus, the distribution, though having a fair market value of $30,000, would be deemed to have been a dividend only to the extent of one-half of the current earnings and profits, or $15,000; undistributed taxable income of $30,000 would be passed through and actually taxed only to the extent of the remaining one-half, $15,000.[127]

While an *additional* cash distribution of $15,000 during the year would have reduced the undistributed taxable income account by that amount, the *overall* immediate tax cost to the stockholders would not have been changed though the cash distribution would have changed the relative extent to which the first two items would be taxed. In apportioning current earnings and profits among what now would be three items, the proposed regulations provide that such earnings shall first be assigned to any cash distributions, and only the balance will be subjected to the ratable allocation previously described.[128] The cash distribution would constitute a dividend of $15,000, and would serve to reduce both undistributed taxable income and current earnings and profits by a like amount, leaving only $15,000 of earnings and profits to be allocated between the distribution in kind ($30,000) and the new reduced undistributed taxable income account of $15,000. Thus the distribution in kind would be a dividend to the extent of $10,000 (2/3), and only $5,000 (1/3) of the $15,000 undistributed taxable income account would actually be passed through and taxed to the shareholders, based on the ratable allocation of remaining earnings and profits.

In the first illustration above, where only a distribution in kind of $30,000 was made, quite a different result would have followed if the corporation also had accumulated earnings and

126 Proposed Treas. Reg. §1.1373-1(e) (1959).

127 That part of the undistributed taxable income which cannot be passed through will presumably be immune from tax.

128 See note 126 supra.

profits, say—of $50,000 as of the first of that same taxable year. In that event, the accumulated earnings are adequate to accommodate what otherwise would have been non-taxable, specifically, the remaining $30,000 ($15,000 of the distribution in kind and $15,000 undistributed taxable income), making a total of $60,000 which the stockholders must include in their gross incomes. However, if the corporation had distributed $30,000 in cash instead of the $30,000 non-cash asset, the cash distribution would have reduced the undistributed taxable income to zero, with the consequence that the stockholders would have included a total of only $30,000 in their gross incomes.

From the foregoing, it should be clear from the standpoint of immediate tax cost to the shareholders that the difference between a distribution in kind and a cash distribution will arise only where there are accumulated as well as current earnings and profits. And essential to this difference is the fact that only cash distributions reduce the undistributed taxable income account. In effect, but only in effect, the difference in the immediate tax burden, where both types of earnings exist, presumably reflects a congressional determination to require a pass-through of the product of *current* activity even though there is a distribution in kind, provided only that there are prior earnings out of which it could be said the distribution in kind was made.

In terms of planning, it appears from the foregoing discussion that where only current earnings and profits exist, a distribution in kind equal to that amount will involve less immediate tax cost to the stockholders than would an "income-realizing" sale by the corporation, followed by a distribution of the cash proceeds.[129]

But where there are adequate prior accumulated earnings and profits to accommodate the distribution in kind, it may be less costly immediately for the corporation to sell the asset and distribute the cash proceeds as a dividend.[130] While the sale will

[129] Where, as in the first illustration, the value of the asset exceeds its adjusted basis to the corporation by $10,000, sale by the corporation would increase the corporation's "taxable income" and current "earnings and profits" from $30,000 each to $40,000 each. As a consequence, an additional $10,000 will be passed through to the shareholders, though this might be treated as long-term capital gain by them, depending on the character of the original asset to the corporation. This latter possibility is considered in the next sub-topic.

[130] While not likely to be of much significance in the typical §1371 setting, it should not be forgotten that the subchapter S election will automatically terminate if more than 20% of the corporation's gross receipts for the taxable year is derived from gains on sales or exchanges of stock or securities. I.R.C., §1372(e)(5).

increase the corporation's taxable income, this increase and the increase in the undistributed income to be passed through will be limited to the gain on the sale. For example, in the second illustration above, a sale followed by distribution of the proceeds would result in passing through $40,000 of income to the shareholders, though $10,000 of this amount might be treated as long term capital gain depending on the character of the asset to the corporation.[131] The competing distribution in kind would result in $60,000 in ordinary income.[132]

Treatment of Items Endowed With a Peculiar Complexion. Congress has not followed a consistent philosophy in treating a variety of items which are generally endowed with peculiar tax characteristics. But perhaps the inconsistency is not without substantive reason, apart from the asserted congressional desire to keep the provisions of subchapter S "simple."[133]

Unlike partnerships, only that item of corporate income which reflects an excess of net long-term capital gain over net short-term capital loss retains its peculiar character when it is included in the shareholders' gross incomes, and then only to the extent of the corporation's taxable income.[134] Instead of obtaining a pass-through of net long-term capital loss, the stockholder will benefit only if a carryover of such loss by the corporation will reduce future excess net long-term capital gains

131 The capital gain possibilities are explored under the next sub-topic.

132 This distribution in kind creates two problems regarding basis. I.R.C., §301(d)(1) states that the basis of the distributed property is to be its fair market value ($30,000). If this is to be the rule irrespective of the amount taxed to the shareholders, an immediate sale of the distributed property by them, the price being its fair market value, would result in no further realized gain to them.

The other basis problem relates to the shareholders' stock in the corporation. If the corporation sells appreciated property and distributes the $30,000 proceeds, then regardless of whether the corporation had prior accumulated earnings and profits, the basis of the shareholders' stock will be increased by the excess of its taxable income ($40,000) over the $30,000 cash distributed. I.R.C., §1376(a). If, on the other hand, the corporation distributes the appreciated property in kind, the basis of the shareholders' stock will be affected as follows: if the corporation has no prior accumulated earnings and profits, the amount of undistributed taxable income passed through ($15,000) will in effect be offset, due to §301(c)(2), against the amount of the property distribution which cannot be allocated to current earnings and profits, also $15,000. If the corporation has prior accumulated earnings and profits sufficient to accommodate both the undistributed taxable income and the distribution in kind, the stock basis will be increased by the amount of undistributed taxable income passed through to the shareholders.

133 See S. Rep. 1983, 85th Cong., 2d sess., p. 88 (1958).

134 I.R.C., §1375(a). The proposed regulations provide for ratable allocation of capital gains to various distributions made during the taxable year. Proposed Treas. Reg. §1.1375-1(c) (1959).

which would otherwise pass through and be taxable to him as such. Perhaps the explanation behind the difference in the two treatments can be traced to the probability that most excess capital losses will be attributable to stock market losses. The refusal to allow a pass-through here is consistent with the underlying premise reflected in another previously described provision, to the effect that the election will completely terminate if more than 20 percent of the corporation's gross receipts are derived from a personal holding company type source. In other words, Congress did not seem to be particularly interested in the non-active-trade-or-business side of small business. The pass-through of excess capital gains can be explained on the ground that these are frequently attributable to corporate disposition of section 1231 assets, i.e., involve assets which were intimately associated with the active side of the corporation's business.

Consider also in the foregoing connection the varying effects which might result if our section 1371 corporation held a limited amount of state or municipal securities for investment purposes. Subchapter S does not include a special provision calling for a pass-through of the tax-exempt characteristic of interest derived from such securities. But under the regulations, while the interest is not a part of "taxable income," it does increase earnings and profits.[135] As a consequence of this combination of circumstances, the interest will retain its tax exemption as a practical matter only if it is never distributed.[136]

If in the first year under the subchapter S election, the corporation has $10,000 in taxable income and $1,000 in tax exempt interest, a cash distribution of $11,000 in that year would be taxable to the shareholder, without dividend benefits, to the extent of $10,000; the remaining $1,000 would be taxable as a regular dividend out of earnings and profits.[137]

If the interest is not distributed in the year earned, it will not be includible in the shareholders' gross incomes for that year as it is not part of the corporation's undistributed taxable

135 Treas. Reg. §1.312-6(b).

136 Since a subchapter S election eliminates the corporate tax entirely, interest of this type could be "exempt" from tax, if at all, only at the shareholder level.

137 This is true because the denial of dividend "benefits" on current distributions by a §1371 corporation is limited to distributions out of current earnings and profits, but only to the extent of the corporation's taxable income. I.R.C., §1375(b). See note 98 supra.

income. But since the interest will increase accumulated earnings and profits,[138] a distribution in the following year which exceeds that year's earnings and profits plus any prior undistributed taxable income will result in regular dividend treatment of the excess attributable to the tax-exempt interest.[139] Thus the overall effect is similar to the treatment of tax-exempt interest received by a regular corporation which has not made the subchapter S election. This again suggests that Congress was primarily concerned only in cushioning the impact of those taxes associated directly with the active conduct of a business.

While the denial of one other benefit carries out this theme, it can actually be explained on another even more persuasive ground. Reference here is to the refusal to allow a section 1371 corporation to enjoy the normal 85 percent dividends-received deduction against dividend income in computing the taxable income which will be passed through to the stockholders.[140] The 85 percent deduction was designed to cushion the impact of what otherwise, in a regular corporate setting, would have been a triple tax. This possibility is thwarted in a section 1371 setting by the election itself, for it immunizes from tax all of the recipient corporation's income. To allow also the 85 percent dividends-received deduction would convert that deduction into a cushion against the so-called double tax, since the deduction would reduce that portion of the recipient-corporation's taxable income which would be taxed directly to the stockholders. It was never contemplated that the 85 percent deduction would affect the so-called double tax problem.

D. *Key Problems Associated With the Death of a Stockholder*

Inadvertent Termination of the Election. Careful planning is necessary with regard to the testamentary disposition of stock

138 While this item might increase the corporation's accumulated earnings and profits beyond $100,000, a §1371 corporation is not subject to imposition of the §531 penalty tax on unreasonable accumulations. See I.R.C., §1372(b)(1).

139 If the shareholders so elect, any excess over current earnings and profits can be treated as coming from accumulated earnings and profits and thus subject to regular dividend treatment. See Proposed Treas. Reg. §1.1375-4(c) (1959).

140 I.R.C., §1373(d)(2). Again it should be cautioned that if the corporation derives more than 20% of its gross receipts for the taxable year from dividends, the subchapter S election will terminate. I.R.C., §1372(e)(5).

in a section 1371 corporation if inadvertent termination of the election on the death of one shareholder is to be avoided. It is clear that if the stock is placed in a testamentary trust, the election will terminate, and cannot again be invoked without the consent of the government until five years have expired.[141] Also, the recipient of the stock, whether an individual legatee or the executor of the estate, must consent to the election within thirty days or there will be a termination,[142] and even if a buy-sell agreement is in force, the stock would pass to the executor until it is purchased by either the corporation or the other shareholders. Thus care must be taken to see that the executor and later the purchaser file timely consents.

Tax Liabilities Immediately Following Death. Any undistributed taxable income of a corporation's current year will be taxable to those who are shareholders as of the close of the *corporation's* taxable year.[143] Thus, in many instances a deceased shareholder's estate will be taxed for the full amount of income attributable to what had been the decedent's stock. When coupled with the estate tax to be paid on the decedent's interest in the corporation, the tax liability imposed on the estate may be rather severe, as the income does not appear to be "income in respect of a decedent" for which an offsetting deduction against the estate tax is allowed.[144] Accordingly, it may be desirable for the shareholders to provide that sufficient funds will be available to the estate of a deceased shareholder for the purpose of discharging the estate's tax liabilities. A buy-sell agreement will provide funds equal to the value of the decedent's stock, but it may also be desirable to specify that the estate is entitled to a distribution equal to the tax on the amount of corporate income attributed to it.[145]

In designing the price formula in connection with a buy-sell

141 I.R.C., §1372(e)(3) and (f). A trust may not be a stockholder of a §1371 corporation.

142 Proposed Treas. Reg. §1.1372-3(b) (1959).

143 I.R.C., §1373(b).

144 The income would not appear to qualify as "income in respect of a decedent" under I.R.C., §691(a) since it is not income to which the decedent was entitled at the time of his death. See Treas. Reg. §1.691(a)-1(b).

145 It is not clear whether the estate would be considered a "member of a family group" with regard to the waiver doctrine applicable to disproportionate distributions to members of such a group. See Proposed Treas. Reg. §1.1375-3(d) (1959). The waiver doctrine is discussed in the text accompanying note 155 infra.

agreement, a pro-rata portion of the corporation's undistributed earnings for the fractional part of the year preceding his death will probably be linked, value-wise, to his shares. But it must not be forgotten that if the agreement is to be carried out before the close of the corporation's taxable year, the undistributed income of the corporation for that whole taxable year will be taxable in full to the remaining acquiring stockholders. The same problem arises in connection with a stock redemption plan. And in such case it may also become important that the corporation have sufficient funds available for distribution to permit the remaining shareholders to satisfy their increased tax liabilities as well as the costs associated with the redemption.

While the problems which may arise on the death of a shareholder thus present some serious difficulties, it seems fair to say that if proper planning is undertaken, they should not discourage use of a subchapter S election.

III. CONCLUSION REGARDING SECTION 1371 CORPORATIONS

General Observation. Adoption of subchapter S is some recognition of the fact that it is not easy in terms of *tax* policy to justify substantial differentials in tax based solely on differences in *private law* forms selected by small enterprises which will actually operate in much the same manner regardless of the particular private law form selected. But if substantial differentials cannot be justified as a matter of tax policy, then a serious question is raised with regard to whether Congress should allow small businesses to shift back and forth among *tax* forms to which it continues to assign different tax implications. Does it really make sense to authorize a pass-through doctrine during an initial period of anticipated losses, then allow the small entrepreneur to neutralize the doctrine during a subsequent profitable period when anticipated expansion makes the corporate rate much more attractive than individual rates, and wind up by permitting completion of the circle through re-invocation of the pass-through concept when the expansion program is over and the corporate tax is no longer desirable? But while a single system for taxing small business, without regard to any question of form, might make more sense in terms of tax policy standing alone, the fact is that tax policy never stands alone. And there may be economic and social reasons why small business should be allowed a reduced

rate (the corporate rate applicable to most small businesses) during a period in which it will use its profits to expand, and also to say that it will not, during other periods, be subjected to the so-called double tax.

Specific Inappropriate Uses of Subchapter S. Whatever else may be said of subchapter S, one can be sure that attempts will be made to subvert it through types of use not contemplated by Congress nor consistent with its underlying purpose.

For example, tax lawyers have already been asked whether it is possible through incorporation of an existing business and election under subchapter S, to facilitate an active 65-year-old proprietor's desire to obtain social security benefits. While the government has statutory authority to deny a tax deduction for the excess portion of excessive salaries paid for the services of a sole stockholder, some cases indicate that for tax purposes an officer-stockholder will not be required to charge his corporation the full value of his services.[146] As a consequence, some single proprietors have raised the question whether they might incorporate, file a subchapter S election, and obtain social security benefits by fixing their salaries at $1200 per year, the balance of the profits to be taken out as "dividends." Obviously subchapter S was not adopted to facilitate any such subterfuge, though in the end a statutory amendment may be necessary to foreclose the possibility.

Again, in 1954, Congress designed a formula in section 337 which would allow a regular corporation to dispose of its assets, as a step toward liquidation, without suffering a corporate tax though the value of the assets far exceeded their adjusted basis. The liquidation would be a tax reckoning event only to the stockholders. However, section 337 included certain restrictions. Now such a corporation may seek the same benefit without complying with those restrictions, choosing instead to make a particularly timely election under subchapter S. If subchapter S is literally followed, the result would be that any net long-term capital gain (§1231) on disposition of the assets would pass through as such and be taxed to the stockholders. Inclusion by them would increase the basis of their stock, immunizing the increment in value from further tax on ultimate liquidation.

146 See Pat O'Brien, 25 T.C. 376, 386 (1955), and George M. Gross, 23 T.C. 756, 773 (1955), affd. (2d Cir. 1956) 236 F. (2d) 612.

A reading of the committee reports gives the impression that Congress sought through subchapter S to aid the development of small businesses, not assist further in its liquidation.[147] In any event, in an effort to prevent the enjoyment of these apparently unintended benefits, the proposed regulations state that a corporation is not eligible to make a subchapter S election if it is in the process of complete or partial liquidation, has adopted a plan to that effect, or contemplates liquidation or the adoption of such a plan in the near future.[148] As there is nothing in the statutory provisions or pre-enactment material which can justify this position, however, it is difficult to speculate on the effect of the regulation. Of course, the regulation in no way affects the benefits to be derived by a corporation which has been operating under a subchapter S election in a bona fide manner before it contemplated liquidation.

Use of the election also provides opportunity for shareholders of a collapsible corporation to avoid the effects of section 341 in certain circumstances. Rather than the shareholders risking an ordinary income tax on the disposition of their stock prior to the corporation's realization of income on the sale or exchange of section 1231 property, for example, they may have the corporation sell the property and thus obtain a capital-gain pass-through. The corresponding increase in the shareholders' basis will reduce the ultimate gain to be realized on disposition of the stock or on liquidation of the corporation.

The proposed regulations have also attempted to minimize the benefits which might be enjoyed in this manner. In addition to the statement that a corporation contemplating liquidation cannot make a subchapter S election, the regulations specifically provide that section 341 may be applicable to dispositions of stock in a section 1371 corporation.[149] They also state that an electing corporation cannot treat as capital gain any gain from the sale or exchange of property which would not have been a capital asset in the hands of the shareholders owning a substantial portion of the stock, if the corporation is availed of by such shareholders for the purpose of selling that property.[150] There is no apparent

147 See S. Rep. 1983, 85th Cong., 2d sess., p. 87 (1958).
148 Proposed Treas. Reg. §1.1372-1(a)(2) (1959).
149 Proposed Treas. Reg. §1.1372-1(c)(8) (1959).
150 Proposed Treas. Reg. §1.1375-1(d) (1959).

basis for such a position in the statute itself, however.[151]

"One shot" elections may also provide favorable tax treatment for qualified corporations as in the case of a large capital gain or net operating loss in a particular taxable year, if the shareholders choose to act in this manner. The proposed regulations indicate, however, that a section 1371 corporation will generally be denied permission to *change* its annual accounting period where the effect may be to shift or defer income, or pass-through a short-period net operating loss or long-term capital gain.[152]

It is also likely that those who would have made gifts of an interest in an enterprise, followed by formation of a family partnership, will now substitute incorporation and the subchapter S election. The *in terrorem* type of regulations associated with family partnerships have not been carried over to this newer setting,[153] though Congress and the Treasury were not completely unaware of the problem. The statute, however, does not go beyond authorizing the Commissioner to re-apportion income taxed to the stockholders if such is necessary to reflect the value of services rendered by family shareholders.[154] The Treasury proposes to add in the regulations that if there is a disproportionate distribution of dividends to members of a family group, apart from the matter of services, the member receiving less than his pro rata share will be deemed to have waived his right to a proportionate distribution, unless he can show that the distribution was made without his consent.[155] And if the waiver concept is applied, the amount distributed is then to be re-allocated among all members of the group in proportion to the shares owned by each. These two limitations are obviously justified, their purposes being to preserve the integrity of *Lucas v. Earl*[156] and *Helvering v. Horst*.[157]

Unanswered Questions Regarding Reorganization of Existing

151 But cf. I.R.C., §341(e).

152 See Proposed Treas. Reg. §1.442-1(b)(1) (1959).

153 Reference has already been made to the requirement proposed by the Treasury that shareholders in a §1371 corporation must have acquired their stock in a "bona fide" transaction. See note 89 supra and accompanying text. In this connection, the proposed regulations state: "Transactions between members of a family will be closely scrutinized." Proposed Treas. Reg. §1.1373-1(a)(2) (1959).

154 I.R.C., §1375(c).

155 Proposed Treas. Reg. §1.1375-3(d) (1959). See note 145 supra.

156 281 U.S. 111 (1930).

157 311 U.S. 112 (1940).

Businesses To Facilitate the Subchapter S Election. Certain existing enterprises which would like to be brought under the shelter of section 1371 may be precluded from doing so because of their existing structure. And the question will arise whether a corporate reorganization, designed to facilitate this objective, would enjoy the benefit of the nonrecognition provisions.

Suppose, for example, that two entrepreneurs had formed a corporation some years ago, taking back a small amount of stock and a substantial amount of bonds. One of their aims was to reduce the impact of the so-called double tax. On an occasion or two, the bonds have been subordinated in order to obtain additional outside financing. Because of some fear that the government might now deny the interest deduction to the corporation, the two entrepreneurs are interested in a subchapter S election. Query: do they not now run the risk that the debt obligations which they hold will be considered a second class of stock, thereby disqualifying the corporation from use of the subchapter S election?[158] Again, while a recapitalization, picking up the bonds in exchange for new stock of the same class as that now outstanding would solve this problem, would the recapitalization itself be excluded from the nonrecognition provisions? Would the argument that the recapitalization was carried out solely for the purpose of avoiding federal taxes, i.e., to free the corporation from the corporate tax, lead to a prejudicial invocation of the old business purpose requirement?

Again, suppose some years ago that Small and Smaller Business had initially separately incorporated the building which was to house the factory. The building was then leased at a fair rental to the corporation which operated the factory. The aim of this arrangement was to make maximum use of the corporate surtax exemption, paying only the 30 percent rate, so that it would be possible more quickly to pay off a purchase money mortgage which ran against the building. The mortgage has now been discharged, and the two men would like to make a subchapter S election covering the whole enterprise, building and factory. The difficulty is that a corporation may not invoke section 1371 if more than 20 percent of its gross receipts is derived from rent.[159]

[158] The proposed regulations apparently purport to treat as a separate class of stock, "stock which is improperly designated as a debt obligation." Proposed Treas. Reg. §1.1371-1(g) (1959).

[159] I.R.C., §1372(e)(5). See note 91 supra.

This would not present a problem following merger of the two enterprises; the surviving corporation would not enjoy any rental income, for it would simply be using its own building. But could the merger be carried out on a nonrecognition basis, or could it be argued again under the business purpose requirement that the sole purpose was to avoid federal taxes which could not otherwise have been avoided?

The impact of the business purpose requirement in settings such as these will be the subject of a later comment.