

1939

## TAXATION - SOCIAL SECURITY - DISSOLUTION OF CORPORATION AND FORMATION OF PARTNERSHIP AS MEANS OF AVOIDING TAX

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### Recommended Citation

Arthur P. Boynton, *TAXATION - SOCIAL SECURITY - DISSOLUTION OF CORPORATION AND FORMATION OF PARTNERSHIP AS MEANS OF AVOIDING TAX*, 37 MICH. L. REV. 986 (1939).

Available at: <https://repository.law.umich.edu/mlr/vol37/iss6/28>

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TAXATION — SOCIAL SECURITY — DISSOLUTION OF CORPORATION AND FORMATION OF PARTNERSHIP AS MEANS OF AVOIDING TAX — The *O* Company surrendered its corporate charter and began operating under an agreement purporting to establish a partnership relation between the former officers and employees whereby complete management including power to employ, discharge and control the duties of its members was vested in a "board of control" elected by and subject to changes made by the majority in interest. Net profits and losses were shared in proportion to the respective interests. The firm could be dissolved only by a vote of the majority in interest and not by transfer of interest, death or resignation of a member. Advice was requested of the Internal Revenue Bureau whether this organization was a partnership for purposes of the social security taxes. *Held*, that the organization as such was not a partnership but an "association" taxable as a "corporation" for purposes of Titles VIII and IX of the Social Security Act, and individuals performing services for the organization were "employees" thereof for purposes of those titles. S. S. T. 337, INT. REV. BULL., No. 43, p. 6 (Oct. 24, 1938), 1 C. C. H. UNEMPLOYMENT INSURANCE SERVICE, ¶ 8722 (1938).

Before the tax under Titles VIII<sup>1</sup> and IX<sup>2</sup> of the Social Security Act can be levied, it is essential that there exist between an individual who performs services of whatever nature and the person for whom such services are rendered the legal relationship of employer to employee.<sup>3</sup> It follows that if the relation

<sup>1</sup> 49 Stat. L. 636 (1935), 42 U. S. C. (Supp. 1937), § 1001.

<sup>2</sup> 49 Stat. L. 639 (1935), 42 U. S. C. (Supp. 1937), § 1101.

<sup>3</sup> Reg. 90, art. 205 (1936), and Reg. 91, art. 3 (1936), under the Social Security Act.

between the person performing services and the one for whom they are performed is that of partners, the social security tax would not apply either to the partners or the firm.<sup>4</sup> This was apparently the idea of the *O Company* when it began operating under the supposed partnership agreement. However, recent rulings of the Internal Revenue Bureau have greatly minimized the possibilities of avoiding the taxes by organizing a partnership. The bureau has held that since the term "person," which includes a corporation, and the term "corporation," which includes an association, are defined in identical terms in the Social Security Act and Revenue Act of 1936,<sup>5</sup> therefore an unincorporated organization which is treated as an association (and thus a corporation) for federal income tax purposes should also be treated as an association (and thus a corporation) for purposes of the social security taxes.<sup>6</sup> The test for determining what organizations are included in the term "association" and consequently to be treated as corporations, thus made applicable to the social security tax, is set out in Article 1001-2 of Regulations 94 of the Revenue Act of 1936 as follows:

"It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute or otherwise."

Since this is the test, it is clear that a bona fide partnership relation in the strict sense of the word will be required to avoid the tax. Certainly the mere description or designation of the relationship by the parties as that of partnership will not in itself be sufficient.<sup>7</sup> Nor will any organization lacking the controlling

<sup>4</sup> 49 Stat. L. 636, §§ 801, 804, 901 (1935); 42 U. S. C. (Supp. 1937), §§ 1001, 1004, 1101. By these provisions the social security tax is levied as an excise tax on employers and as an income tax on employees. Of course, as to persons performing services who are not partners, a partnership may be an employer and to that extent be subject to the social security taxes. Reg. 90, art. 205 (1936), Reg. 91, art. 4 (1936): "An employer may be an individual, a corporation, a partnership. . . ." See Reg. 90, art. 204, (1936), and Reg. 91, art. 4 (1936), as to when an employer is subject to the social security taxes.

<sup>5</sup> Section 1101 of the Social Security Act, 49 Stat. L. 647 (1935), 42 U. S. C. (Supp. 1937), 1301, and Section 1001 of the Revenue Act of 1936, 49 Stat. L. 175 (1935), 26 U. S. C. (Supp. 1937), § 1696, both contain the following definitions: "The term 'person' means an individual, a trust or estate, a partnership, or a corporation." "The term 'corporation' includes associations, joint-stock companies, and insurance companies."

<sup>6</sup> S. S. T. 284, INT. REV. BULL., No. 16, p. 19 (April 18, 1938), 1 C C H UNEMPLOYMENT INSURANCE SERVICE, ¶ 5110. 501 (1938), 5 U. S. LAW WEEK 1082 (1938).

<sup>7</sup> Reg. 90, art. 205 (1936), and Reg. 91, art. 3 (1936), under the Social Security Act: "If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if two individuals in fact stand in the relation of employer and

factors indicative of the creation of an ordinary partnership, either in its formal articles of agreement or in its actual method of operation, be able to avoid the taxes.<sup>8</sup> Thus though an organization may be treated as a partnership for some purposes, unless it is managed and dissolved as an ordinary partnership it will apparently be deemed an association taxable as a corporation. Individuals performing services for the organization will be considered "employees" of the association under the tax provisions of the Social Security Act.<sup>9</sup> This practically eliminates the possibility of large corporations being converted into partnerships to avoid the tax. Any such attempt would, from the desires of the interested parties, result in an organization with features that would make an association, taxable as a corporation, and the members employees of the corporation.<sup>10</sup> However, there appears to be no reason why a small corporation may not avoid the taxes by converting itself into a partnership, assuming that the burden of the social security taxes may be sufficient to offer an incentive to change to a new relationship.<sup>11</sup>

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employee to each other, it is of no consequence that the employee is designated as a partner. . . ."

<sup>8</sup> S. S. T. 337, INT. REV. BULL., No. 43, p. 6 (Oct. 24, 1938), I C C H UNEMPLOYMENT INSURANCE SERVICE, ¶ 8722 (1938).

<sup>9</sup> S. S. T. 337, INT. REV. BULL., No. 43, p. 6 (Oct. 24, 1938), I C C H UNEMPLOYMENT INSURANCE SERVICE, ¶ 8722 (1938). By section 1101 of the Social Security Act, 49 Stat. L. 647 (1935), 42 U. S. C. (Supp. 1937), § 1301, the term "employee" includes an officer of a corporation. The management of any organization which is deemed an association and therefore a corporation would be officers of a corporation and "employees" under the social security tax.

<sup>10</sup> Reg. 94, arts. 1001-2, 1001-4 of the Revenue Act of 1936 would seem to require that there be a community of interest or control for all partners and that the organization be subject to dissolution by the transfer of any partner's interest or by death or resignation of any partner.

<sup>11</sup> Similarly, the owner of a small unincorporated business may avoid these social security taxes by entering into partnership agreement with his employees, provided he does not retain such control of the business as to make the partnership relation illusory.