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William P. Cunningham

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SUBCHAPTER S CORPORATIONS: USES, ABUSES, AND SOME PITFALLS

By WILLIAM P. CUNNINGHAM*

The Subchapter S Corporation, a creature of interest to the owners of small businesses and their lawyers, was born in 1958 with the enactment of the Technical Amendments Act of 1958,[1] which added Subchapter S[2] to the Internal Revenue Code. The technical aspects of these new provisions of the Code are complicated; to acquire a workable understanding of their operation demands considerable effort. Final Regulations[3] have recently been issued under these provisions and a number of comprehensive articles have been published that would be helpful to those seeking a technical mastery of the area.[4] It is not the purpose of this article to replow this ground. Rather, the objective is to help the general practitioner faced with making a decision on the advisability of his client's electing Subchapter S tax treatment. At this juncture, the lawyer especially needs help (1) in spotting those situations where the use of Subchapter S would be appropriate, and (2) in

* A.B. 1944, LL.B. 1948, Harvard University; Professor of Law, University of Maryland School of Law.

[1] P.L. 85-866, § 64(a), 72 Stat. 1650 (September 2, 1958).

[2] INTERNAL REVENUE CODE OF 1954 (hereinafter called I.R.C.), §§ 1371-1377.

[3] T.D. 6432, Dec. 18, 1959, Regs. 1.1371-1 to 1.1377-3.

[4] Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Colum. L. Rev. 1146 (1958); Comment, *Subchapter S: A New Concept in the Tax Status of Business Associations*, 44 Cornell L. Q. 560 (1959); Comment, *Subchapter S Tax Option for Small Business Corporations*, 7 Univ. of Kan. L. Rev. 523 (1959); Comment, *Tax Election Corporations: Subchapter S of the Internal Revenue Code of 1954*, 47 Calif. L. Rev. 351 (1959); Hoffman, *Let's Go Slow with Tax Option Corporations*, 37 Taxes 21 (1959); Meyer, *One Year of Subchapter S*, 38 Taxes 105 (1960); Moore and Sorlien, *Adventures in Subchapter S and Section 1244*, 14 Tax L. Rev. 453 (1959); Murdoch, *Effect of Subchapter S on Decisions as to Form of Business Organization*, 38 Taxes 19 (1960); Note, *Optional Taxation of Closely held Corporations under the Technical Amendments Act of 1958*, 72 Harv. L. Rev. 710 (1959); Note, *Practitioners' experience with Subchapter S reveal many doubts, fears; use is limited*, 10 J. Taxation 130 (1959); Note, *Subchapter S of the 1954 Code*, 33 St. John's L. Rev. 187 (1958); Willis, *Subchapter S: A Lure to Incorporate Proprietorships and Partnerships*, 6 U.C.L.A. L. Rev. 505 (1959); Wright and Libin, *Impact of Recent Tax Stimulants on Modest Enterprises*, 57 Mich. L. Rev. 1131 (1959).

planning and drafting arrangements among the owners of a business desiring to operate through a Subchapter S corporation that will tend to minimize potential friction between the various shareholders that might otherwise develop as a consequence of Subchapter S tax treatment of the business income.

USES

When to use a Subchapter S corporation should not be treated as an isolated problem, for it is one aspect of a broader problem — determining the best type of business organization to use in various business situations. Weighing the tax and non-tax considerations involved in the choice of a form of business organization has long been one of the most difficult tasks that lawyers have to handle. Congress, in enacting Subchapter S, sought to simplify this task by reducing the importance of the tax factors involved, through allowing a business in corporate form to elect approximately the same tax treatment it would have received had it been organized as a partnership. The enactment of Subchapter S was desirable, according to the Senate Committee Report on the bill, ". . . because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences".[5] This statement has been called ". . . almost incredibly naive . . .",[6] for, now, more than ever, it is necessary to consider tax factors. Before Subchapter S, the usual choice was between corporation and partnership. Instead of making corporation and partnership equivalent tax-wise, Subchapter S has added a third alternative, the Subchapter S corporation. Thus, the task of the lawyer and business advisor has become considerably more complex.[7]

According to a 1959 report, 62,000 businesses have already elected Subchapter S tax treatment.[8] Despite this evidence of an initial favorable reaction to Subchapter S, it would seem unwise to assume that Subchapter S will be

[5] Senate Finance Committee Report No. 1983, *1958 U.S.C. Cong. & Adm. News*, 4791, 4876; the Report continued (at 4876):

". . . In this respect, a provision to tax the income at the shareholder, rather than the corporate, level will complement the provision enacted in 1954 permitting proprietorships and partnerships to be taxed like corporations. Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business."

[6] Freeland & Stephens, *The Commissioner and the Corporation*, 11 Univ. of Fla. L. Rev. 509, 535 (1958).

[7] Moore & Sorlien, *supra*, n. 4, 457.

[8] *1959 P-H Federal Taxes*, ¶ 32,621.

used on a grand scale. Certainly, the enactment of Subchapter S does not mean that every business that previously selected partnership for tax reasons will now incorporate and elect Subchapter S tax treatment. Nor does it mean that small corporations will jump at the chance to elect Subchapter S tax treatment merely because the tax structure otherwise imposes a "double tax" on corporate earnings, once at the corporate tax rate, and then again at the individual rates of the shareholders when such earnings are distributed as dividends. Subchapter S will have no appeal for those owners of small businesses who are successfully using the corporate form so as to have the business earnings taxed at the corporate tax rate in lieu of any individual tax on the owners, as, for example, where the corporate earnings are retained in the corporation and used to finance the growth of the business. In such situations, the owners will not want to substitute individual tax rates for the corporate tax rate — the chief effect of a Subchapter S election. Subchapter S should not be sold in wholesale lots; rather, the choice between partnership, corporation, and this new alternative, a Subchapter S corporation, turns on the proper assessment of each individual business situation.

At the outset, the particular business situation must be examined to determine whether the Code's qualifications for electing Subchapter S tax treatment can be met. To govern this question of eligibility, the Code sets out an elaborate definition of a "small business corporation".[9] To be so classified, a business must be a domestic corporation that does not: (1) own more than 80% of the stock of another corporation,[10] (2) have more than ten shareholders, (3) have a shareholder (other than an estate) who is not an individual,[11] (4) have a shareholder who is a non-resident alien, or (5) have more than one class of stock.[12] Moreover, to retain such classification, a Subchapter S corporation must stay within certain limitations on the type and source of its income. Not more than 80% of its gross receipts can be derived from foreign sources nor can more than 20% of its gross receipts be derived from royalties, rents, dividends, interest, annuities, and gains from the sale of securities.[13]

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[9] I.R.C. § 1371(a).

[10] This negative characteristic results from the rule that a small business corporation can not be a member of an affiliated group (as defined in I.R.C. § 1504).

[11] See Reg. 1.1371-1(e).

[12] See Reg. 1.1371-1(g).

[13] I.R.C. § 1372(e)(4) and (5).

Even though a business can meet these requirements, once met they can not be forgotten, for the business will not be able to keep its Subchapter S tax treatment if, at some future time, it violates these restrictions. A Subchapter S election entails serious disadvantages because of the restrictions that these "qualification" rules impose with respect to the tax and estate planning of the individual owners and with respect to the operations and investments of the business itself.

The loss of freedom in estate planning is especially significant. Testamentary trusts can not be used by the shareholders since a trust can not be a shareholder of a Subchapter S corporation. Distribution of stock among the members of a shareholder's family, by will or gift, is hampered because of the rule that there can not be more than ten shareholders. Some estate plans require an issue of preferred stock for eventual distribution to non-active members of a shareholder's family. The Subchapter S corporation, however, can have only common stock. Also, the voting trust device can not be used with a Subchapter S corporation.[14]

A business may find it difficult to keep its dividend, interest, and rent income, plus its gains from security sales, at less than 20% of its gross receipts. At the least, keeping constant check on the business operations to make sure that this limit is not exceeded adds a bothersome detail to the duties of corporate management. Also, a Subchapter S corporation is precluded from having any subsidiary, by reason of the rule that a Subchapter S corporation can not be a member of an "affiliated group" as defined in I.R.C. § 1504.[15] A corporation with a large amount of debt in relation to the amount of its stock capital may run afoul of the rule that a Subchapter S corporation can have only one class of stock.[16]

The complicated rules governing the tax treatment of business income under the Subchapter S election create various difficulties that should be considered additional disadvantages of a Subchapter S corporation. For instance, every adjustment in the Subchapter S tax return for the corporation, such as a change in its depreciation deduction,

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[14] A choice between freedom in estate planning and Subchapter S tax treatment need not be made until a conflict between the two actually develops. As the business prospers and estate planning becomes a serious problem, it is likely that the owners (now in higher tax brackets) will want to terminate the Subchapter S election anyway.

[15] See Reg. 1.1371-1(c).

[16] See Reg. 1.1371-1(g); Caplin, *Subchapter S and its Effect on the Capitalization of Corporations*, 13 Vand. L. Rev. 185 (1959).

requires a corresponding adjustment in the tax returns of each individual owner. A partnership has the same problem, but the inter-relationship between the return of a Subchapter S corporation and its shareholders is at a higher level of complexity than that between the returns of a partnership and its partners. The additional accounting expense a Subchapter S election entails may be a significant item to a small business.

The rule that a shareholder of a Subchapter S corporation must report as income his share of the corporation's undistributed taxable income existing on the last day of the corporation's taxable year presents difficulties in the case of sales of stock during the year, and inequities when a shareholder dies during the year. The buyer of stock must report as his income the whole year's "constructive dividend" no matter how late in the year he made the purchase. It may be possible to adjust the purchase price of the stock to compensate the buyer for this extra tax burden, but this adjustment may be awkward at the least.[17] Similarly, even though a shareholder dies toward the end of the corporation's taxable year, his estate must include its proportion of the entire year's earnings in the estate's income tax return.[18]

The Subchapter S corporation, since its distinctive features have their origin in the federal law, is unfavorably treated under most state income tax laws. The Code encourages the actual distribution of a Subchapter S corporation's earnings to its shareholders since no additional tax results therefrom. Yet dividend distributions will mean extra taxes under many state income tax laws.[19] For example, corporate earnings paid out as salaries to shareholder-employees are taxed at 3% under the Maryland income tax, while the same earnings distributed as a dividend would be subject, first, to the 5% Maryland corporate income tax, and, second, to a 5% Maryland individual income tax.

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[17] It is also important to withdraw earnings on which the seller has already paid income taxes, since the right to receive such earnings out of the corporation without further tax can not be transferred to the buyer. If a cash shortage makes this unfeasible, the seller might return the amounts involved to the corporation as a loan.

[18] Apparently I.R.C. § 691 (Income in Respect of Decedents) does not apply to such income items; therefore, the estate does not get any deduction for estate tax paid on such amounts under I.R.C. § 691(c). See Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Colum. L. Rev. 1146, 1169 (1958).

[19] Stine, *Subchapter S election may increase state income tax on corporation or stockholders*, 10 J. Taxation 91 (1959).

In considering the general disadvantages of electing Subchapter S tax treatment, the fact that the election can be abruptly terminated by acts of a single shareholder creates a sense of uncertainty in the tax picture of all shareholders. Although such terminations can be guarded against by proper planning,[20] such plans mean restraints on shareholders' rights, as well as additional lawyer's fees. The least tangible, but for many perhaps the most significant, consideration against making the election lies in a general fear of the new and unknown, particularly justifiable here in view of the chance that, sooner or later, Subchapter S will be repealed.[21]

If a small business can meet the Code's qualifications for Subchapter S election and the general disadvantages of such an election, already mentioned, have been considered and found not too serious, the next step for the tax planner is to examine the chief features of Subchapter S tax treatment as they apply to his particular situation. The Senate Finance Committee Report on Subchapter S indicated three types of business situations in which the use of a Subchapter S corporation could be desirable:

> "It will be primarily beneficial to those individuals who have marginal tax rates below the 52-percent corporate rate (or 30-percent rate in the case of the smaller corporations) where the earnings are left in the business. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates since in this case a 'double' tax is removed. The provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses."[22]

The suggestions of the Committee assume the existence of a corporation, the question of choice being merely whether or not to make the election. The possibility of operating

[20] See text, *infra*, p. 209 *et seq.*; Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 Tax L. Rev. 453, 489 (1959), observe that such shareholder arrangements "When drawn for all possible protection . . . become something of a monstrosity" and that the difficulties involved may constitute a decisive factor against making the election in some situations.

[21] Note, *Practitioners' experiences with Subchapter S reveal many doubts, fears; use is limited*, 10 J. Taxation 130 (1959); Hoffman, *Let's Go Slow With Tax Option Corporations*, 37 Taxes 21, 28 (1959).

[22] Senate Report No. 1983, *1958 U.S.C. Cong. & Adm. News* 4791, 4876.

the business as a partnership is assumed unavailable as an alternative. This, of course, will be the case where the business is already in existence in corporate form or where there are compelling non-tax reasons for using a corporation. In examining the Committee's suggestions, let us make the same assumption, for eliminating the partnership alternative simplifies the problem.

As the Committee indicated, the first thing to do is to make a comparison between the corporate tax rate and the rates of the individual shareholders. The corporate rate starts out at 30%, and moves up to 52% for corporate incomes over $25,000. This means the average corporate rate for an annual income of $25,000 or less is 30%; for $50,000, an average rate of 40%, and for $100,000 an average rate of 46%. An individual will not reach a tax rate over 30% till his taxable income exceeds $8,000 ($16,000 if he is married and files a joint return). Perhaps more relevant, the individual's average tax rate does not exceed 30% till he reaches roughly $14,000 ($28,000 if a joint return). To take a concrete example, if A and B own a corporate business making $20,000 a year, and A and B's only income is the $10,000 each receives out of the business, a Subchapter S election would seem desirable.

But more is involved than merely comparing the corporate rate and the individual rates. The amounts that shareholders can withdraw from the business in the form of salary is an important factor. If all the shareholders are employees of the business and all the corporate earnings can be taken out as salary, there is no need for a Subchapter S election since the only tax on the business earnings would be the individual income tax — roughly the same result as is achieved by an election. In fact, there are some definite advantages in using the salary route rather than Subchapter S. The chief advantage of the salary route is that it provides a more flexible tax planning arrangement. The salary route permits the owners to split the corporate earnings so that a part is taxed at the corporate rate and the balance (that part withdrawn as salary) is taxed at the individual rates. Especially as the individual owners reach the higher tax brackets, a combination each year of the corporate rate and the individual rates often provides the optimum over-all tax result.[23]

[23] The salary route has other advantages, available whether or not a Subchapter S election is made: (1) Under the Maryland state income tax there is a 7% differential in favor of withdrawals as salary as compared with withdrawals as dividends. (2) Withdrawals as salary provide a higher base for contributions to a qualified pension or profit-sharing plan.

On the other hand, even though all the shareholders are employees, if they want to retain some of the business earnings in the corporation and are in low individual brackets, a Subchapter S election may be indicated. Referring back to our example of A and B owning a business with $20,000 annual earnings, if A and B wanted to leave $10,000 each year in the business and take out as salary only $5,000 apiece, a Subchapter S election would result in a total immediate annual saving of $800 in federal income taxes (assuming both A and B are married and file joint returns).[24]

Regardless of the relative rates of the corporation and its shareholders, if the shareholders are not employees and an appreciable part of the corporate earnings are distributed as dividends, a Subchapter S election will reduce federal taxes. For example, a widow, inheriting her husband's interest in a close corporation, will usually favor a Subchapter S election. That is to say, where corporate earnings are subject to "double" taxes because distributed as dividends, the election, by eliminating the corporate tax, will result in tax savings.

If a business is losing money in its operations, a Subchapter S election will be advantageous. Here, the higher the individual rates in comparison to the corporate rate, the greater the advantage of an election will be. Once such losses exhaust a shareholder's basis for his stock and his loans to the corporation, however, the election becomes disadvantageous.[25]

For the successful small business that is growing steadily and needs to retain its earnings, Subchapter S has no appeal, at least where the individual rates approximate the corporate rate. Such shareholders hope to take out the corporate earnings at capital gain rates through eventual liquidation of the business or sale of their stock, or perhaps hope to avoid even the capital gains tax by waiting until

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On the other hand, an advantage of the salary route combined with a Subchapter S election is that the danger of controversy with the Internal Revenue Service as to the "reasonableness" of salaries will be greatly reduced; but see Hoffman, *supra*, n. 21, 25.

[24] The Subchapter S election would eliminate a $3,000 (30% times $10,000) corporate tax at the expense of $2,200 in individual taxes (roughly a 22% tax bracket for A and B).

[25] Once the shareholder's basis is exhausted, any additional losses are neither deductible currently nor usable in any later year. Reg. 1.1374-1(b)(4). It should also be noted that an existing corporation with a large net operating loss carryover would be unwise to elect Subchapter S tax treatment in view of Reg. 1.1374-1(a). See Note, 72 Harv. L. Rev. 710, 715 (1959).

their deaths step up the basis for the stock to its fair market value.[26]

Where it is possible to operate the business as a partnership, there are additional factors to consider and weigh before deciding to use a Subchapter S corporation. Whenever a new business is started (assuming that non-tax considerations do not demand the use of a corporation[27]), or where an existing business is being conducted as a partnership, a tax comparison between partnership and Subchapter S corporation should be made. When a business is started, some lawyers use an old tax rule of thumb — begin as a partnership and change to a corporation when the business becomes successful. This general rule may have some validity still, despite the enactment of Subchapter S. That is, it would be dangerous to incorporate all new businesses on the theory that should partnership tax treatment turn out to be preferable a Subchapter S election could then be made; for there are some important differences tax-wise between partnerships and Subchapter S corporations. Partnership may still be the best form to use in many situations. And it must be kept in mind that the shift from a partnership to a normal corporation or a Subchapter S corporation may be made without tax consequences, while a shift in the opposite direction can be costly tax-wise.[28]

Let us first examine the tax advantages of a Subchapter S corporation over a partnership. The chief advantage is that a Subchapter S corporation can confer on shareholder-employees a number of so-called fringe benefits that are not available to partners since partners are not considered employees of the business for tax purposes.[29] The most valuable of these fringe benefits is a qualified pension or profit-sharing plan. Such plans have four tax virtues: (1) The corporation gets an immediate tax deduction for amounts it puts into the plan. (2) The employee is not taxed until he receives the benefits. (3) If the employee withdraws his benefits in a lump sum he can get capital gain treatment.

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[26] See Note, 72 Harv. L. Rev. 710, 720 (1959).

[27] The chief non-tax advantages of a corporation are usually listed as (1) limited liability, (2) transferability of shares, and (3) continuity of existence despite the death of an owner. The answers of partnership partisans to these alleged advantages are: (1) serious liability risks can be insured against, (2) stock in a small business from a practical viewpoint is not readily transferable, at least to outsiders, and (3) by skillful drafting, the partnership agreement can adequately handle the problems posed by a partner's death.

[28] The shift to a corporation is "tax-free" under I.R.C. § 351, while the shift to a partnership from a corporation may involve a heavy capital gains tax under I.R.C. § 331.

[29] Note, *Fringe benefits important factor in considering Subchapter S election not to be taxed*, 9 J. Taxation 376 (1958).

(4) The pension, or profit-sharing, fund, itself, can accumulate its earnings free of tax. In addition, a shareholder-employee of a Subchapter S corporation can get the tax benefits of an accident and health plan, which means that the medical bills of both the employee and his family can be paid by the business without any tax to the employee.[30] Similarly, tax-free "sick-pay" (I.R.C. § 105(d)) and meals and lodgings in kind (I.R.C. § 119) are available to the shareholder-employee of a Subchapter S corporation. I.R.C. § 101(b), excluding from income death benefits paid by an employer to the deceased employee's family up to $5,000, can also be exploited by the Subchapter S corporation.[31] There are signs that these advantages of a Subchapter S corporation over a partnership may be too good to last. In September, 1959, Chairman Mills of the House Ways and Means Committee introduced a bill that would prevent the use of all these fringe benefits by Subchapter S corporations.[32] If these fringe benefits are taken away, it is hard to conceive of any situation where Subchapter S tax treatment would be better than that accorded a partnership.

A less significant advantage of the Subchapter S corporation lies in its ability to adopt as its taxable year a different period than the taxable years of its shareholders. Because "constructive dividends" of Subchapter S corporations are deemed received by shareholders at the end of the corporation's taxable year, if the shareholders' taxable years end just before that of the corporation, they can postpone paying any tax on the initial earnings of the business for a period up to 23 months.[33] Moreover, different taxable years allow shareholders to control, to some extent, the year in which the business earnings will be reportable by them, since, by actually paying out a dividend, the shareholders can report the earnings on their tax returns a year earlier than such earnings otherwise would be reportable.[34]

On the other hand, a partnership has some definite tax advantages over a Subchapter S corporation. Under partnership tax treatment, income and deduction items have the

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[30] *Ibid.*

[31] Mickey & Wallick, *Tax saving plans under Subchapter S now more reliable as a result of new regulations*, 10 J. Taxation 268, 271 (1959).

[32] H. R. 9003, § 2, introduced September 1, 1959, and still in the House Committee on Ways and Means. H. R. 10, passed by the House, and in the Senate, also should be watched, since it would extend the advantages of pension plans to partners and self-employed individuals.

[33] Wright & Libin, *Impact of Recent Tax Stimulants on Modest Enterprises*, 57 Mich. L. Rev. 1131, 1145 (1959); Note, 10 J. Taxation 130, 133 (1959). § 5 of H. R. 9003 (*supra*, n. 32), if enacted, would block the use of different fiscal years in most situations.

[34] Mickey & Wallick, *supra*, n. 31, 269.

same tax character in the partners' tax returns at they had in the partnership return. With Subchapter S corporations, however, the conduit idea has a much more limited application. Only long-term capital gains and net operating losses pass through the Subchapter S corporation without losing their advantageous tax character. Tax-exempt interest and life insurance proceeds passing to partners from a partnership retain their tax-exempt quality in the partners' hands, but such items become taxable in the hands of a Subchapter S corporation's shareholders.[35]

Partners are also treated more favorably under state income tax laws. For instance, under the Maryland income tax law, a Subchapter S corporation is not specially treated, and thus must pay a 5% tax on its earnings. When these earnings are passed on to its shareholders as dividends, the shareholders must pay a second 5% tax. In contrast, partners receiving business income pay a single 3% tax. This 7% differential constitutes a significant factor in favor of partnership over the Subchapter S corporation. Also, under Maryland law, operating losses of the business are deductible by partners, but they can not be exploited at all by shareholders of a Subchapter S corporation. As to Social Security taxes, partners have to pay only three-quarters as much as do shareholder-employees of a Subchapter S corporation.[36] Where several individuals want to start a business and make their capital contributions in the form of property, it is possible under a partnership agreement to do equity between the owners and adjust for the differences between the basis of the property contributed and its current market value.[37] Such adjustments are not feasible if the business is organized as a Subchapter S corporation. There are a number of other minor advantages of the partnership over the Subchapter S corporation that may be significant in particular situations.[38]

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[35] Reg. 1.1377-2(b).

[36] For 1960, a partner's self-employment tax rate is 4½%, while the combined rate of a corporate-employer and shareholder-employee is 6%. Similarly, Maryland and Federal Unemployment Compensation Taxes and workmen's compensation premiums must be paid with respect to shareholder-employees by a corporation while with a partnership such costs are avoided.

[37] See Reg. 1.704-1(c); Willis, *A Lure to Incorporate Proprietorships and Partnerships*, 6 U.C.L.A. L. Rev. 505, 507 (1959).

[38] Partnerships have various technical advantages over Subchapter S corporations: (1) as to Additional First Year Depreciation (I.R.C. § 179); (2) as to long-term compensation averaging (I.R.C. § 1301); (3) as to the use of losses in excess of the owner's basis for his interest (*cf.* I.R.C. § 704(d) and § 1374(c)); and (4) as to the pass through of long-term capital gain despite the existence of operating loss for the year (see Note, 72 Harv. L. Rev. 710, 719 (1959)). As to the comparison of partnerships

One conclusion from this detailed comparison of the partnership, the corporation, and the Subchapter S corporation is inescapable: the enactment of Subchapter S has not made the job of selecting the best form of doing business any easier. Another conclusion is that business situations in which the Subchapter S corporation clearly should be used will be comparatively rare.

ABUSES

Although there may be only sporadic use of Subchapter S corporations as a result of weighing the factors already suggested, commentators have pointed out numerous opportunities for abuse of Subchapter S, using "abuse" in the sense of a use advantageous tax-wise that seems to be contrary to the spirit and purpose of the Subchapter as envisioned by Congress in enacting it. It is not unlikely that these abuses, or "gimmick" uses, will result in repeal of the whole Subchapter.[39] Distinguishing between the legitimate and the illegitimate in tax planning is often difficult.[40] The newness of this legislation makes it particularly difficult to draw the line. In any event, for a full picture of Subchapter S, the lawyer should be aware of the nature and variety of these potential abuses.

The most frequently mentioned abuse is the so-called "one-shot election"; that is, electing Subchapter S tax treatment for one or two years and then deliberately revoking or terminating the election. Such one-shot election may be advantageous where the business has an usually large capital gain in prospect.[41] Suppose a mercantile business owns a building that has greatly appreciated in value. Under normal corporate taxation, on selling the building the corporation would have to pay a 25% capital gain tax and then, on distribution of the cash proceeds to its shareholders, the shareholders would pay an individual tax on the dividend received. If, however, a Subchapter S elections is made for the year in which the sale is to occur, at the most a 25%

and Subchapter S corporations in general, see Willis, *supra*, n. 37, 510; Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 Va. L. Rev. 61 (1960).

[39] Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Colum. L. Rev. 1146, 1175 (1958).

[40] The problem may not involve ethics so much as the exercise of sound judgment (reaching a decision that will prove wise in the long-run). See generally Paul, *The Lawyer as a Tax Advisor*, 25 Rocky Mountain L. Rev. 412 (1953); and *Ethical Problems of Tax Practitioners*, 8 Tax L. Rev. 1 (1952).

[41] Roberts & Alpert, *Subchapter S: Semantic and procedural traps in its use; analysis of dangers*, 10 J. Taxation 2 (1959).

tax is levied; for the long-term capital gain would not be subject to tax in the corporation and would be taxed at only capital gain rates on distribution of the cash to the shareholders.[42] Another one-shot election possibility exists where a loss year is anticipated; the Subchapter S election is made for that year so that the shareholders can exploit the operating loss on their individual returns, and then the election is terminated the following year. It has also been suggested that the Subchapter S election can be used (1) to avoid in certain situations the effect of the "collapsible corporation" provision,[43] and (2) on liquidation of the business as a substitute for Section 337.[44]

Subchapter S may be exploited by a one-man business in questionable ways. For example, a manufacturer's agent, or a public relations consultant, may decide to do business as a corporation in order to get the advantages that corporate employers can give to their employees, particularly pension and profit-sharing plans.[45] Also, the Subchapter S election may be used to get cash out of a one-man corporation with accumulated earnings and profits, without payment of an individual tax, by paying a high enough salary to the owner-employee so as to cause the corporation an operating loss for the year. Since the Subchapter S shareholder can deduct the loss from his salary income, he is only taxed on the difference between the salary and the loss; thereby getting cash out of the corporation without tax to the extent of this manufactured loss.[46] The Subchapter S provisions may enable an individual to avoid the

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[42] If the capital gain on the sale of the building (plus the corporation's other "investment" income) exceeds 20% of its gross receipts for the year, the corporation will forfeit its right to Subchapter S tax treatment; see I.R.C. § 1372(e)(5). § 4 of H.R. 9003, *supra*, n. 32, if enacted, would severely limit the "usefulness" of this maneuver.

[43] Anthoine, *supra*, n. 39, 1171. § 4 of H.R. 9003, *supra*, n. 32, if enacted, would eliminate this "gimmick" use of Subchapter S.

[44] Anthoine, *supra*, n. 39, 1173; Note, *Unforeseen effects of Subchapter S are big help in liquidations, other tax planning*, 10 J. Taxation 223, 224 (1959).

[45] Anthoine, *supra*, n. 39, 1166; Note; *Fringe benefits important factor in considering Subchapter S election not to be taxed*, 9 J. Taxation 376 (1958); but see Rev-Rul. 57-163, Part 4(a), 57-1 C.B. 128, 139.

[46] The salary must still be "reasonable", see Reg. 1.162-7 and Reg. 1.1372-1(c)(1); if the salary deduction is disallowed, there will be no net operating loss. See Note, *How to use election under new law to save taxes on small corporations, owners*, 9 J. Taxation 263, 264 (1958). It has also been suggested that a sole proprietor over 65 years old may incorporate and exploit the Subchapter S election to avoid the Social Security rule against working beneficiaries earning over $1,200 a year. See Wright & Libin, *Impact of Recent Tax Stimulants on Modest Enterprises*, 57 Mich. L. Rev. 1131, 1168 (1959); but see OASI Bureau Letter, 3/6/59, 1A *CCH Unemployment Insurance Reporter*, p. 4185.

so-called "hobby loss" provision[47] by setting up his hobby business in a corporate shell, and electing Subchapter S.[48]

Sometimes where a closely held business has been split up among several corporations, it may be possible to make the election for those corporations likely to suffer losses, and not elect for those corporations whose stock is appreciating in value. The resulting combination of gains at capital gain rates and losses offsetting ordinary income may be particularly attractive to high bracket shareholders.[49]

It has been suggested that a Subchapter S corporation can be profitably used to shift income within a family group so as to minimize the total family tax bill.[50] To illustrate, if a father and two sons owned a corporation, the father, if in higher tax brackets than his sons, would find it advantageous to take a low salary from the corporation and thereby increase the amount of corporate earnings flowing to his sons by way of dividends. I.R.C. § 1375(c) would appear to block such misuse of a Subchapter S corporation. This section, however, is limited to readjusting the amounts taxable to the various shareholder-members of the family group where artificially low salaries are paid to shareholder-employees. Suppose the father gave all his stock to his sons (perhaps retaining control through an irrevocable proxy to vote the shares)[51] and the father continues to perform substantial services for the corporation at a low salary. The diversion of the father's compensation income to the sons that occurs in this situation is not covered by I.R.C. § 1375(c).[52] A limited shift of income to the sons can be achieved by giving the sons stock just before the end of the corporation's taxable year, for then the stock's pro rata share of the corporation's earnings for the whole year is taxable to the sons rather than to the father.[53]

Combining the Subchapter S election with distributions of dividends in kind may enable shareholders to realize gains and get cash out of the corporation without any tax at all. This "gimmick" is rather involved, and may best be

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[47] I.R.C. § 270.

[48] Note, 10 J. Taxation 133 (1959); but see Reg. 1.1374-2.

[49] See Note, 72 Harv. L. Rev. 710, 715 (1959); Anthoine, *supra*, n. 39, 1162.

[50] Anthoine, *supra*, n. 39, 1167.

[51] See Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W. 2d 679 (1947). See also O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1958) §§ 5.36 and 6.15; 2 MD. CODE (1957), Art. 23, § 43(b)(2).

[52] Note, 9 J. Taxation 263 (1958); Meyer, *Subchapter S Corporations*, 36 Taxes 919, 924 (1958). The Commissioner might successfully tax the father, however, on the theory that assignments of compensation will not be recognized tax-wise, Helvering v. Eubank, 311 U.S. 122 (1940); Rev-Rul. 55-2, 1955-1 C.B. 211.

[53] Reg. 1.1373-1(a).

explained through using a hypothetical situation. Assume T sets up a Subchapter S corporation with a $50,000 capital contribution, assume that the business earns $10,000 a year, and that it invests $20,000 in stock that pays low dividends but has high growth potential. Assume further that in a few years the stock purchased by the corporation appreciates in value to $40,000. If this stock is then distributed to T as a dividend in kind, the only tax consequence to T is that the basis of his stock in the Subchapter S corporation is reduced by $32,000.[54] Moreover, T now has a $40,000 basis for the stock distributed to him and thus he can sell it for $40,000 and will have no gain on the sale. To escape the individual dividend tax in this situation, the Subchapter S corporation must have no accumulated earnings and profits; and a business that starts as a Subchapter S corporation will not usually have any appreciable earnings and profits because its income is taxed currently to the shareholders. Thus, the enactment of Subchapter S may breed new interest and activity in the dividend in kind area.[55]

Subchapter S does not seem to be sound legislation. It may be abused more than it is used; if so, it probably will not endure as a permanent part of the federal tax structure. But while it lasts, it is a tool to be used with restraint, and only after thoughtful consideration of its risks and disadvantages and after a careful weighing of the available alternatives.

Some Pitfalls To Avoid In Setting-Up A Subchapter S Corporation.

Once the decision has been made to elect Subchapter S tax treatment, the lawyer's job has barely begun, for there remain some pitfalls that should be guarded against through planning and action at the time of election. The problems arise mainly because there are numerous acts and events listed in the Code that will cause abrupt termination

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[54] See Reg. 1.1373-1(g) (Example (3)). One-fifth (10,000/50,000) of the property distribution (1/5 times $40,000 = $8,000) is treated as a distribution of current earnings, which would be taxed to T anyway under I.R.C. § 1373 as a constructive distribution. The balance ($40,000 minus $8,000 = $32,000) is treated as a reduction in the basis of T's stock in his Subchapter S corporation under I.R.C. § 301(c)(2). Moreover, if the S corporation sold this stock itself, rather than distributing it as a dividend in kind, it would be likely to lose its Subchapter S tax status in view of I.R.C. § 1372(e)(5). See Wright & Libin, *supra*, n. 46, 1160.

[55] See generally Mintz and Plumb, *Dividends in Kind — The Thunderbolts and The New Look*, 10 Tax L. Rev. 41, 44 (1955).

of the Subchapter S election.[56] Some of these acts are within the unfettered control of a single shareholder, such as the transfer of stock owned by him to a trust, partnership, or corporation, or to an individual who refuses to consent to Subchapter S tax treatment. A disgruntled minority shareholder can, by causing the termination of the election, seriously prejudice the tax situations of the other shareholders. On such a termination, not only will the majority lose the tax treatment of the business income that they prefer, but a termination has a retroactive effect that can cause considerable loss to the other shareholders. For instance, the shareholders may lose their chance to withdraw as a return of capital previous years' earnings on which individual taxes have already been paid. Moreover, when dividends have been paid over early in the year on the assumption that Subchapter S treatment will apply to the year, the unexpected termination of the election will result in the imposition of a corporation tax in addition to the individual tax on the business earnings distributed during the year.[57] There are also numerous ways in which the management of the corporation can cause the termination of the election, providing a fertile source of controversy between majority and minority interests.

Before detailed planning to meet these problems can begin, a fundamental policy decision must be made. Are changes in Subchapter S status to be determined by a majority of the shareholders, or is unanimous approval of the shareholders to be required? It is almost axiomatic that rule by a majority, in most business situations, is the only practical way to govern corporate affairs. Subchapter S status, however, is not an issue that affects the well-being of the corporate entity as such, but it is a question that directly affects the well-being of each individual shareholder and the attitude of each shareholder as to Subchapter S status is likely to be determined chiefly by the individual's income tax bracket. It is unlikely, however, that the majority shareholders, as the controlling group, will want Subchapter S decisions to require either unanimous shareholder consent, on the one hand, or to be left to the whim of a single shareholder, on the other. In most business situations, the majority probably will have enough power and influence, either formal or informal, to force the minority shareholders to accept majority rule for Subchapter S questions as well as for ordinary business de-

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[56] I.R.C. § 1372(e).

[57] Note, *Practitioners' experiences with Subchapter S reveal many doubts, fears; use is limited*, 10 J. Taxation 130, 133 (1959).

cisions. Certainly a majority would be wise to try to achieve such an arrangement.

There are some businesses, however, that must be organized, or already have been established, on the basis of unanimous consent of the shareholders for all important decisions, the so-called "incorporated partnership". In such cases, it is likely that the only feasible way to handle Subchapter S questions will be on the same basis. Also, there may be situations where a majority-run corporation can obtain the consent of all to a Subchapter S election only by agreeing to a rule of unanimity for Subchapter S questions.

If no control arrangements as to Subchapter S questions are worked out at the time of elections, the control situation will vary depending on what Subchapter S question is in issue; a rule of unanimity will apply to election and formal revocation while termination of the election will be within the power of the corporate management and also within the power of each individual shareholder. Thus, the tax law breeds a control situation that is not only unsound in theory but likely to be chaotic in operation. The differing tax brackets of the shareholders of a Subchapter S corporation will often lead them to antagonistic positions on Subchapter S questions. Therefore, unless a Subchapter S corporation is so closely held that it is safe to assume that antagonistic positions among the shareholders will not develop in the future, it is important not to leave the control situation unresolved, but to adopt some definite control arrangement for Subchapter S questions.

So that the difficulties involved in devising control arrangements can be appreciated, the various ways in which the Subchapter S election can be terminated will be set out in some detail. There are a number of events causing termination that are within the absolute control of a single shareholder. Perhaps the simplest device of all is for a shareholder to transfer stock to a trust; such a trust may be a short-term revocable trust that, in reality, may be little more than a sham.[58] Transfer of some stock to a partnership, or to another corporation, or to an individual who would constitute the eleventh shareholder of the Subchapter S corporation would also terminate the election. A method of termination often available involves the transfer of some shares to an individual that the transferor has ascertained in advance would refuse to consent to a continuance of the election. The most painful termination method available to an individual shareholder is to move

[58] See Reg. 1.1371-1(e) and Reg. 1.1372-4.

his residence to a foreign country and renounce U. S. citizenship.[59]

In those instances where an act of the individual shareholder was deliberately done to destroy the Subchapter S election, the question arises whether the courts will disregard such deliberate act as one made "in bad faith", or without proper "business purpose", and therefore rule that the attempted termination of the election was ineffective. The decision may turn on whether the deliberate act was the sole idea of a single shareholder against the wishes of the majority, or whether the act was instigated by the majority. It seems probable, though, that in either case such acts will be effective to terminate the election, for the Code, itself, spells out the "penalty" for termination,[60] *i.e.*, the corporation loses its right to Subchapter S treatment for five years. Moreover, in the Regulations, both types of termination are covered; the distinction is made between terminations caused by an individual maverick shareholder and terminations instigated by shareholders having a substantial interest. In the latter situation the five year penalty is imposed while in the former the Commissioner can shorten the five year penalty period.[61] Since the problem of deliberate termination is covered so explicitly by statute, legislative history, and regulations, it is unlikely that a court would nullify a termination on the general theory of improper tax motive. After all, Subchapter S is an optional tax treatment. It seems odd to look on a return to normal tax treatment as improper tax avoidance. The Government would seem on firmer ground in attacking an initial election as beyond the purpose and intent of the Subchapter than in attacking merely the termination of an election on such grounds.[62]

In addition to the various deliberate acts of termination, an individual shareholder can involuntarily cause termination by dying, followed by the failure of his executor or administrator to consent to Subchapter S treatment within 30 days after such representative has been appointed.[63] This termination possibility presents serious difficulties for the planner seeking to guard against its occurrence. These difficulties stem from the fact that normally it will be

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[59] A "non-resident alien" shareholder would disqualify the corporation; I.R.C. § 1371(a).

[60] I.R.C. § 1372(f).

[61] Reg. 1.1372-5(a).

[62] Note, 33 St. John's L. Rev. 187, 207 (1958).

[63] Moreover, the consent can not be filed later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder, Reg. 1.1372-3(b).

against the interest of the estate and its legal representative to consent to a continuance of the election, since, under Subchapter S rules, the estate will have to include its share of the whole year's income of the corporation as a "constructive dividend" even though the estate has owned the stock for only a part of the year.[64] A particularly troublesome problem arises if a shareholder dies just before the end of the corporation's taxable year and no legal representative is appointed within the period of 30 days following the end of the corporation's taxable year.[65]

The corporate management has even more ways to terminate the Subchapter S election than does the individual shareholder. One comparatively simple method is for corporate management to so conduct the corporation's business that more than 20% of the gross receipts of the business constitute personal holding company type income, as defined in the Code and regulations.[66] Rents, dividends, interest and gains from stock sales are the principal types of income so classified. Similarly, termination ensues if more than 80% of the corporation's gross receipts are derived from sources outside the United States.[67] Under a 1959 amendment of the Code, the acquisition of 80% or more of the stock of another corporation will result in termination of the election.[68] Also, termination results if the corporation issues a second class of stock.[69]

In addition to the four methods just described, the corporate management has most of the methods available to the individual shareholder; that is, it can issue stock or sell treasury stock to the persons prohibited from owning

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[64] An executor may feel obligated to refuse consent, unless he gets court approval for such consent (there may not be time for this), or unless the shareholder in his will has explicitly authorized him to consent, or unless a shareholders' agreement has imposed on the estate a duty to consent (see, *e.g.*, the draft agreement, *infra*, p. 221). Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 Colum. L. Rev. 1146, 1169 (1958); Hoffman, *Let's Go Slow With Tax Option Corporations*, 37 Taxes 21, 22 (1959).

[65] As a last resort, the person likely to be executor should file a consent within the time limit in the hope that his subsequent appointment will retroactively validate his action. Also, under Reg. 1.1372-4(b)(iii), the district director may excuse the failure to file a timely consent. See also, Comment, 7 Univ. of Kan. L. Rev. 523, 528 (1959). If heirs of a deceased shareholder deliberately refuse to take out administration in order to force the termination of the election in disregard of a contractual obligation to consent, other shareholders may be able to take out administration and consent for the estate; see 8 MD. CODE (1957), Art. 93, §§ 34 and 67.

[66] I.R.C. § 1372(e)(5) and Reg. 1.1372-4(b)(5).

[67] I.R.C. § 1372(e)(4).

[68] I.R.C. § 1371(a) and § 1372(e)(3) in combination with the amendment to § 1504 enacted by P.L. 86-376, § 2(c), effective September 24, 1959.

[69] I.R.C. § 1371(a) and § 1372(e)(3).

Subchapter S corporation stock, or to an individual who refuses to consent to a continuance of the election.

With the numerous ways a Subchapter S election can be terminated in mind, we can turn to the problems involved in devising control arrangements for determining Subchapter S questions. As has been indicated, a control arrangement based on majority rule is the desirable one for most business situations. At the outset, we run into the difficulty that a majority control arrangement seems to run counter to the policy of Subchapter S, in view of its requirement of unanimous consent of the shareholders for both election and formal revocation. What was the purpose behind these Code requirements? At first blush, it may appear that Congress was concerned with constitutional difficulties in imposing on individual shareholders taxes on undistributed corporate business income without their consent. In this connection, it is interesting to note that the Subchapter S regulations[70] indicate certain shareholders will be subject to Subchapter S without any consent on their part to the election and thus provide some indication that constitutional worries were not the reason for the unanimous consent requirement.[71] The requirement of unanimous consent may have been used to facilitate tax administration. Requiring the signature of each shareholder to the election would avoid the contention by a shareholder that he was unaware of the election and did not, therefore, realize his duty to report his share of the corporate business income on his individual return. On the other hand, Congress may have felt that the minority shareholders needed the protection given by this requirement of unanimous consent to prevent imposition upon them by the majority shareholders. But, even assuming that the Code's provisions were designed in some part to protect minority shareholders, it now seems generally accepted by most courts, at least in corporation law, that an individual can waive statutory provisions enacted for his benefit, unless such waiver itself would violate public policy.[72] Therefore, although in all dealings with

[70] Reg. 1.1372-1(b)(2) (N.B. the final sentence of this subsection).

[71] An individual tax on undistributed corporate profits would seem constitutional under Collector v. Hubbard, 12 Wallace (79 U.S.) 1, 18 (1870), where the court held that it is ". . . as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards. . . ." See also I.R.C. § 551(a) where the undistributed income of a foreign personal holding corporation is taxed directly to United States shareholders, without any consent on their part.

[72] See O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1958), §§ 5.06 and 5.07. In Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E. 2d 829, 837, 159 A.L.R. 280 (1945) Conway, J. (dissenting), said: "[shareholders] . . . may by agreement waive or relinquish as between themselves statutory

the Internal Revenue Service there must be "formal" unanimity to elect and to revoke Subchapter S tax treatment, there is legal precedent to sustain contractual arrangements between the shareholders binding themselves to act with respect to Subchapter S questions in accordance with the will of the majority.

In designing such a control arrangement predicated on majority rule, there are two sources of trouble the majority will want to neutralize: (1) the power of each individual shareholder to sabotage the majority's plan to continue the Subchapter S election, and (2) the potential liability of the majority for action on Subchapter S questions contrary to the best interests of the minority shareholders. Unless the power of the individual shareholder to terminate the election is checked, a disgruntled minority shareholder will have a cudgel that can do considerable damage to the other shareholders and that can be a means of obtaining from the majority unwarranted favors.

The potential liability of the corporate management (or the majority shareholders) for causing termination of the Subchapter S election presents particularly difficult problems. In the first place, this is a new area and what the attitude of the courts will be is unknown. To illustrate some of the difficulties, it is convenient to use a hypothetical situation: A, B, and C incorporate a business, each taking a third of the stock and, as employees, withdrawing most of the profits in the form of salary. Then C dies leaving his shares to his widow. In order to pay over business profits to the widow without having to pay a "double" tax on the dividend distributions, Subchapter S tax treatment is elected. The business prospers and the tax brackets of A and B exceed the corporate tax rate. Moreover, A and B want to expand the business operations and want to build up cash resources within the corporation by retaining most of the business profits. Now, they feel it would be advantageous to terminate the Subchapter S election. The widow of C disagrees; her individual tax rates are lower than A's and B's. In addition, the Subchapter S election tends to result in the distribution of more money as dividends than otherwise would be true, since the business profits are taxed whether distributed or not and the shareholders need cash to pay their individual taxes. Without Subchapter S, the widow, as a minority shareholder, would have difficulty in getting dividends out of the corporation. At this point,

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rights where such waiver or abandonment is not contrary to the public interest." In accord, Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936).

A and B decide to cause terminaton of the election, without the widow's consent, by having the corporation's rent income exceed 20% of its gross receipts, by issuing a second class of stock, or by any of the numerous other ways the election can be terminated by corporate action. On such facts, can the widow successfully maintain an action against A and B for manipulating corporate action for their advantage and to the widow's detriment? In the accumulated earnings tax area, we have a closely analogous situation. There have been indications that the corporate management will be liable to the corporate entity for causing the corporation to incur the I.R.C. § 531 penalty tax, at least where the corporate management has deliberately caused the corporation to incur this penalty tax and the corporate management has been controlled by shareholders who have preferred the penalty tax to individual taxes at high rates on dividend distributions while the minority have preferred dividend distributions to the penalty tax.[73] Similarly, in our hypothetical situation, the widow may assert that A and B should be held liable to the corporation for the amount of corporate tax that had to be paid as a result of A and B's deliberate termination of the Subchapter S election. Certainly the full corporate tax would be an unrealistic measure of damages. Termination of the election has a double aspect; though the corporation incurs the corporate tax, the shareholders are relieved of an individual tax on undistributed business earnings. Thus, a damage computation, to be fair, must involve offsetting the decreased individual taxes against the increase in corporate taxes. Developing a sensible measure of damages, or even a sound theory of liability, in such situations is a hard task.[74] For our present purposes, all that is important is that suits by minority shareholders against the majority for either negligent or deliberate termination of the Sub-

[73] See Note, *Derivative actions arising from payment of penalty taxes under Section 102*, 49 Colum. L. Rev. 394 (1949), and Note, *Corporations — Duties of Directors — Personal Liability of Shareholder-Directors for Accumulating Earnings Which Led to Subjection of the Corporation to Section 102 Taxes*, 61 Harv. L. Rev. 1058 (1948).

[74] Treating this problem as one calling for a derivative suit runs into both theoretical and practical difficulties. Although the injury arises out of improper corporation action, it is not realistic to look upon the injury as involving harm to the corporate entity. Only the minority is actually harmed; moreover, the injury varies as to each minority shareholder depending on his individual tax bracket. Therefore, an individual action by the minority shareholder (or a class action by the minority shareholders) against the majority shareholders would seem a more appropriate remedy than a derivative suit, where the damages are awarded to the corporate entity. See Zahn v. Transamerica Corp., 162 F. 2d 36 (Cir. 1947); see generally, BALLANTINE ON CORPORATIONS (1946), § 143.

chapter S election are dangers that the majority should not lightly dismiss.

Protection against these various dangers can be obtained, most effectively, through use of a shareholders' agreement. An important part of such an agreement involves restricting the transfer of the corporation's shares.[75] Thereby, the majority can obtain protection against the minority shareholder who seeks to cause termination of the election by the sale or transfer of his stock. That is, the restrictions would be used as a means of policing all proposed transfers. Under a first option type of restriction, the corporation would exercise its option to buy the shares, unless it was satisfied that the transfer would not cause termination. If the proposed transfer involved a sale or gift to a new shareholder, necessitating consent by such new shareholder to avoid termination, the corporate management would insist on getting the consent of the new shareholder in advance before permitting the transfer to take place.

Unless the term "shareholder" under the relevant Subchapter S provisions[76] means "shareholder of record", restrictions on transfer, alone, may not be completely effective as a means of preventing termination of the election by individual shareholders. If an individual becomes a "new shareholder" within the provisions of Subchapter S the day he receives a certificate of stock duly indorsed, it would seem possible for a determined minority shareholder to terminate the election despite the agreement's restrictions on transfer. True, he would thereby violate the restrictions, and equity would come to the aid of the majority and require a rescission of the transaction, or a transfer to the corporation under the option provision, but the damage may already have been done. Before the majority may be aware of the actual transfer of the stock certificate, or, perhaps, before remedial action could be taken, the 30 day period in which the new shareholder must consent may have run and the election terminated. Although the Committee Reports on Subchapter S refer at one point to shareholders "of record",[77] it seems likely that the courts will

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[75] Note, 72 Harv. L. Rev. 710, 713 (1959); Moore and Sorlien, *Adventures in Subchapter S and Section 1244*, 14 Tax L. Rev. 453, 487 (1959). See, as to the validity of stock restrictions in general, O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1958), Chapter VII.

[76] I.R.C. § 1372(e)(1) and (3) in combination with § 1371(a).

[77] In discussing who must consent to the original election, the phrase "shareholders of record" is used, Senate Finance Committee Report No. 1983, *1958 U.S.C. Cong. & Adm. News* 4791, 4877; but *cf.* at 5005. See Comment, 7 Univ. of Kan. L. Rev. 523, 527 (1959).

hold that the actual transfer of the stock certificate, rather than the recording of the transfer on the corporate books, is the crucial event.[78] On the assumption that the actual transfer of the certificate is controlling, the effectiveness of the restrictions on transfer may still be preserved by requiring all shareholders to deposit their stock certificates with an escrow agent. If held in escrow, the certificates could not be transferred in violation of the provisions of the shareholders' agreement.[79]

The time a person becomes a shareholder within the meaning of Subchapter S may even antedate the transfer of the stock certificate in some situations where equitable interests are created. In establishing revocable trusts, for example, it is frequently provided that the grantor may retain the stock certificates in his own name instead of making a formal transfer to himself as trustee.[80] If such a disposition of stock is deemed sufficient to create a new shareholder or shareholders for purposes of Subchapter S, then stock restrictions, even when coupled with an escrow arrangement, may prove inadequate. Perhaps a clause in the shareholders' agreement dating the beneficial interest of the corporation under its option from the time of any such trust disposition would successfully meet this problem. If all the above techniques are used, then there is some assurance that the majority will be protected from termination of the election by an individual shareholder, no matter how the term "shareholder" is finally defined.

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[78] The Senate Committee Report did not use the term "shareholder of record" in discussing termination of the election, *ibid*, 5006; nor does the applicable regulation, Reg. 1.1372-4(b)(1). Moreover, Reg. 1.1371-1(d) defines shareholder as follows: "Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation." Even though a corporation may properly pay a dividend to a stockholder of record despite the fact his certificate of stock has been transferred to another, as between transferor and transferee the transferee would be the one beneficially entitled to the dividend and consequently the one required to report the dividend for tax purposes (see BALLANTINE ON CORPORATIONS (1946), § 240). Policy considerations lead to the same conclusion. Unless the actual beneficial owner of stock, as distinguished from the stockholder of record, is deemed the "shareholder" for purposes of Subchapter S, the rules against corporations, partnerships or trusts being shareholders of Subchapter S corporations could be circumvented merely by neglecting to have stock transferred on the books of the corporation.

[79] The escrow agent should not be a trustee, or even loosely called one, in view of the prohibition against a trust's owning shares of a Subchapter S corporation, Reg. 1.1371-1(e).

[80] See generally SCOTT, THE LAW OF TRUSTS (2nd Ed. 1956), § 32. SHATTUCK and FARR, AN ESTATE PLANNER'S HANDBOOK (1953) 445, refers to the ". . . somewhat common custom of executing the trust and then waiting until sometime later to round up the property . . ."

A shareholders' agreement also can establish majority rule for revocation and re-election of Subchapter S tax treatment in place of the rule of unanimity set out in the Code.[81] Such arrangements do not attempt to alter the formal requirements of Subchapter S; they merely add a contractual duty on the part of all the shareholders to comply with these formal requirements whenever the majority determines that revocation or re-election is desirable.

The risk that the majority may be held liable to the minority as a result of corporate action instigated by the majority resulting in Subchapter S termination can be minimized by a provision in the shareholders' agreement specifically releasing the majority from such potential liability. This is, however, a rather delicate matter. As previously pointed out, the majority's liability, if any, would be based on a violation of fiduciary duty. Exculpatory clauses relieving fiduciaries from their normal liabilities are looked upon with disfavor by the courts.[82] This attitude stems from the fact that the exculpatory clause is usually too broad and, if upheld, would provide a shield for the fiduciary with respect to acts that never were contemplated by the parties when they created the fiduciary relationship. It does not seem too dangerous from a public policy standpoint to give the majority absolute power, as long as such power is confined to making decisions on Subchapter S questions. The shareholders in a closely held corporation should be able, by contract, to make their own rules as to their mutual rights and duties, at least in dealing with this Subchapter S area.[83]

To indicate the form that a shareholders' agreement covering the above points might take, a draft of such an agreement is presented below:[84]

> AGREEMENT made this .... day of ...., 1960, between Arthur Able, Brian Baker, and Charles Carr (hereinafter referred to as the Stockholders), and Green, Inc., a Maryland corporation (hereinafter referred to as the Corporation).
>
> WHEREAS the Corporation has elected and the Stockholders have consented under Section 1372(a) of the

[81] I.R.C. § 1372(e)(2) and § 1372(f).

[82] SCOTT, *op. cit. supra*, n. 80, § 222.

[83] See O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1958), § 3.66.

[84] This draft is presented as an aid and not as the answer. Not only will each situation require its own modifications (integration with existing agreements will often be necessary) but this Subchapter S area is so new and many of its problems so novel that one hesitates to suggest that any specific solution, or draft of an agreement, will work out satisfactorily.

Internal Revenue Code of 1954 to tax treatment under the provisions of Subchapter S of the Internal Revenue Code of 1954 (hereinafter referred to as Subchapter S); and

WHEREAS the Stockholders desire that the will of holders of a majority of the shares of the Corporation's stock outstanding from time to time should control matters related to the continuance, termination, revocation, and re-election of Subchapter S tax treatment;

NOW THEREFORE, it is mutually agreed as follows:

1. Simultaneously with the execution of this agreement, all the certificates of the Corporation's stock owned by the Stockholders shall be deposited with the Treasurer of the Corporation, as Escrow Agent. Said Treasurer (and his successors in said office) shall hold the certificates in accordance with the terms of this agreement and for the purpose of assuring that this agreement is performed by all parties hereto. Any certificates of the Corporation's stock hereafter acquired by parties to this agreement shall be deposited forthwith with said Treasurer to be held by him as aforesaid.

2. In the event that any party hereto desires to sell, transfer, or encumber any part or all of his shares of the Corporation's stock (including any disposition of stock, or of an interest in stock, that could cause the termination of Subchapter S tax treatment),[85] he shall first offer such shares of stock for purchase by the Corporation at the book value[86] of such shares as of the close of the month next preceding such offer, said book value to be determined by the Board of Directors of the Corporation. Such determination, including the method thereof and the matters considered therein, shall be final and conclusive. If said offer is not accepted by the Corporation within thirty days of the

[85] The parenthetical phrase, supplemented by the last sentence of this section, is designed to protect against termination of the election as a result of a shareholder's creation of a revocable trust without any actual transfer of the stock certificates. See *supra*, n. 80.

[86] Generally, the use of "book value" to determine the option price is one of the worst methods of valuation; see O'NEAL, *supra*, n. 83, § 7.24. The use of "book value" will tend to increase the deterrent effect of the agreement, since "book value" is usually less than "fair value". Thus, the use of "book value" may be justified where the primary purpose of the agreement is to prevent termination of the election.

receipt thereof, said offeror shall be free to dispose of said shares of the Corporation's stock as he may desire. Should any shares be disposed of in violation of this provision, the equitable interest of the Corporation under this provision in such shares shall date from the date of such disposition.[87]

3. In the event of the death of any party hereto, the executor or administrator of such party shall execute a consent to Subchapter S tax treatment in accordance with and within the time limits provided for in Subchapter S and the regulations thereunder, and shall take such further action and execute such other documents as may be necessary to effectuate the purposes of this agreement.[88]

4. In the event that holders of a majority of the shares of the Corporation's stock then outstanding file a written notice with the Treasurer of the Corporation that they desire to revoke Subchapter S tax treatment pursuant to Section 1372(e)(2) of the Internal Revenue Code of 1954, each party hereto shall execute such consents to such revocation and take such further action and execute such other documents as may be necessary to effectuate such revocation.

5. In the event that Subchapter S tax treatment has been revoked or terminated, and in the further event that holders of a majority of the shares of the Corporation's stock then outstanding file a written notice with the Treasurer of the Corporation that they desire to re-elect Subchapter S tax treatment, each party hereto shall execute such consents to such re-election and take such further action and execute such other documents as may be necessary to effectuate such re-election.

6. No party hereto, no director, and no officer of the Corporation shall be liable in damages or otherwise, or in any other way be held responsible, for the termination of Subchapter S tax treatment where such termination results from action taken (or by reason of failure to act) by the Corporation and where such ac-

[87] This section does not prevent a shareholder from terminating the election by becoming a non-resident alien. Normally this possibility can be safely ignored. It would seem wise to include these restrictions also in the charter of the corporation; O'NEAL, *supra*, n. 83, §§ 3.79 and 7.14; see also 2 MD. CODE (1957), Art. 23, § 4(b)(7).

[88] This section should avoid the difficulties discussed, *supra*, n. 64.

tion, or non-action, as the case may be, has the approval of the Board of Directors of the Corporation.

7. At any time, by the filing of a written notice signed by the holders of a majority of the shares of the Corporation's stock then outstanding with the Treasurer of the Corporation, this agreement may be terminated, or any provision of this agreement may be waived.

8. This agreement shall be binding upon the heirs, executors, administrators, successors, and assigns of all parties to this agreement, and the terms "party" or "parties", as used in this agreement shall include the heirs, executors, administrators, successors, and assigns of the named parties and the heirs, executors, and administrators of assigns of such named parties. All parties bound by this agreement shall execute and deliver any and all documents necessary to carry out the purposes of this agreement.[89]

IN WITNESS WHEREOF, we, the undersigned, have executed and sealed this agreement.

Accepted:

....

Treasurer of Green, Inc.,
as Escrow Agent.

As an alternative to a shareholders' agreement, a charter provision for the redemption of stock may sometimes be used as a means of discouraging minority shareholders from terminating the Subchapter S election. Under such a redemption provision the corporation would be given a right to redeem shares whenever a transfer of such shares has caused the termination of the Subchapter S election. Although a disgruntled shareholder can still terminate the election, such a provision enables the majority to cause the immediate redemption of the shares he has transferred, and thereby puts the majority in a good position to re-elect the Subchapter S tax treatment for the next year.[90] With-

[89] Adequate reference to this agreement should be made on the stock certificates to make sure that any transferee will be bound by it; see O'NEAL, *supra*, n. 83, § 7.16, and 2 MD. CODE (1957), Art. 23, § 114. Before allowing any transfer under § 2 of the agreement, the corporation should require the written consent of the prospective transferee to the Subchapter S election.

[90] Under Reg. 1.1372-5(a), the Commissioner will probably be lenient in allowing a re-election for the next year where a disgruntled minority shareholder has caused termination of the election.

out such a redemption clause, the disgruntled shareholder (or his transferee) can permanently block any attempt by the majority to re-elect Subchapter S treatment. Moreover, if the redemption price set in the charter is less than the current fair value of the shares (which will often be true if "book value" is used as the redemption price), the redemption provision will tend to deter minority shareholders from acts causing termination of the election.

The chief advantage of such a redemption provision over a shareholders' agreement is that it would be less cumbersome to establish and operate. Also, it might be convenient to use where a buy-and-sell agreement between the shareholders has already been established, since the addition of a charter redemption provision may avoid elaborate revision of existing agreements. On the other hand, such a redemption provision provides for a less comprehensive treatment of the problems involved; specifically, it would not establish "majority rule" as to formal revocation and re-election, nor would it explicitly relieve the majority from potential liability for corporate acts causing termination of the election. This redemption provision technique would seem most suitable for use where, because of the particular circumstances, the majority does not consider the risks of revolt by individual shareholders serious, and, thus, are content with half-way measures.

Such a redemption provision can only be used in states permitting redeemable common stock. In a number of states, this point is as yet unsettled.[91] As far as Maryland is concerned, the statute itself explicitly permits redemption provisions as to common stock.[92] Of course, it is still too early to be confident that a redemption provision of the type described (and with such a purpose) will withstand attack in the courts. Not only is redeemable common somewhat novel in itself, but to use a right of redemption to provide majority rule for Subchapter S questions is to take an excursion even further into the unknown. As long as all shareholders consent to a charter amendment creating such a redemption provision, and the local corporation law is not adverse, the chances of judicial approval seem good.[93] To illustrate such a redemption provision, a tentative draft is presented below:

[91] O'NEAL, *supra*, n. 83, § 7.11.

[92] 2 MD. CODE (1957), Art. 23, § 18(a)(5) and § 32.

[93] Lewis v. H. P. Hood & Sons, Inc., 331 Mass. 670, 121 N.E. 2d 850 (1954), would seem to support such a use of a redemption provision. See Note, *Callable Common Stock*, 68 Harv. L. Rev. 1240 (1955); *cf.* Case Comment, *Unqualified Redemption of Common Stock: A Question of Public Policy*, 50 Northwestern Univ. L. Rev. 558 (1955).

ARTICLE .... *Redemption of Common Stock.*

In the event that any shares are transferred to a person who fails to consent to tax treatment under Subchapter S of the Internal Revenue Code of 1954 (hereinafter referred to as Subchapter S) in accordance with and within the time limits provided for in Subchapter S and the regulations thereunder; or, with respect to shares owned by the estate of any deceased shareholder, in the event that Subchapter S tax treatment is not consented to by an executor or administrator of such estate in accordance with and within the time limits provided for in Subchapter S and the regulations thereunder;[94] or, in the event that any shares are transferred or any interest in shares is disposed of in such a way as to cause the termination of Subchapter S tax treatment; then, any or all of such shares referred to above as may be designated by the Board of Directors may be called by the Board of Directors in such manner as they determine at their book value, as determined by the Board of Directors as of the close of the month next preceding such call. Such determination of book value, including the method thereof and the matters considered therein, shall be final and conclusive.[95]

Could a redemption provision be used, also, as a means of forcing recalcitrant shareholders to consent to the original election of Subchapter S tax treatment? This is an intriguing possibility, for, otherwise, there seems no way to elect Subchapter S treatment over the objection of even a single shareholder. A corporate charter is usually amendable by two-thirds of the shareholders.[96] If such two-thirds could amend the charter to include a redemption provision permitting redemption of the stock of anyone who refused to consent to a Subchapter S election,[97] there would be a method to force the election on the minority. What can be accomplished through charter amendment varies from state to state. The Maryland law gives a virtually unlimited power of amendment to the shareholders.[98] But

[94] The shares owned by the estate would be subject to redemption where no executor or administrator has been appointed in time as well as where an executor or administrator refuses to consent.

[95] *Cf.* draft set out in O'NEAL, *supra*, n. 83, § 10.14(2).

[96] 2 MD. CODE (1957), Art. 23, § 11(c)(3).

[97] The redemption clause draft, *supra*, would have to be modified to make refusal to consent to the election an additional ground for redemption.

[98] 2 MD. CODE (1957), Art. 23, § 10. See BRUNE, MARYLAND CORPORATION LAW AND PRACTICE (1953), §§ 115 and 122.

even though such a charter provision were technically permissible under the statute, there is always the risk that such action would run afoul of equitable limitations on changes that can be imposed by the shareholders in control through charter amendment.[99]

Having considered majority control arrangements for Subchapter S questions, let us turn briefly to the problems involved in establishing a rule of unanimity for such questions. As has been pointed out,[100] a rule of unanimity in this area will usually be impractical and unsatisfactory. Yet there may be situations where an arrangement based on unanimous consent of the sharehloders is the only one feasible. For instance, the corporation may have been originally organized on the understanding that all corporate action would require unanimous consent. Or, some shareholders may condition their original consent to the Subchapter S election on the adoption of a rule of unanimity for all subsequent Subchapter S decisions.

Designing an arrangement based on a rule of unanimity, as compared with a majority control arrangement, involves some new problems, while others remain the same, and still others are eliminated. Since Subchapter S itself requires formal consent by all shareholders to both election and revocation, a rule of unanimity is already established; but contractual arrangements are still needed to protect against termination of the election by individual shareholder action as well as by corporate action. Protection from individual shareholder action can be obtained by the same means used in majority control arrangements; that is, through imposing restrictions on the transfer of shares. Establishing a rule of unanimity, however, also requires giving protection to the minority shareholders from termination of the election by the corporate management. In theory, at least, equitable relief may be available to the minority shareholders where the corporate management has caused the termination of the election and it can be

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[99] See generally LATTIN, THE LAW OF CORPORATIONS (1959), 507-515. Using a fairer pricing formula under the redemption provision than "book value" would improve the chances of the charter amendment withstanding attack in a court of equity. In view of 2 MD. CODE (1957), Art. 23, § 10, the argument can be made that as long as a minority can get "fair value" for its stock, the minority should not be able successfully to challenge on equitable grounds any charter amendment adopted by the majority. Against the validity of a redemption provision so used, it may be argued that it violates the "policy" of Subchapter S itself with its requirement of unanimous consent to a Subchapter S election (see text, *supra*, n. 72), and that such an unusual amendment should not be sustained without the unanimous consent of the shareholders (see O'NEAL, *supra*, n. 83, § 3.77).

[100] See text, *supra*, p. 210.

shown that they did so in flagrant disregard of the interests of the minority. But the use of such a remedy is fraught with difficulties.[101]

One relatively simple way to protect the minority from the majority is to give each shareholder a veto power as a part of the corporate structure itself. This can be achieved by having the charter require unanimous consent for both shareholder action and director action (each shareholder would also be a director).[102] A less severe approach would be to require unanimity only with respect to actions that could result in termination of the election. This would entail requiring unanimity as to issues of stock, transfers of treasury stock, waiver of stock restrictions, and charter amendment, combined with charter restrictions as to the type of business activity so as to prevent termination because the gross receipts of the business are of an improper type or source.[103] Either of these approaches, however, involves putting a straight-jacket on the majority shareholders and the corporate management that would usually cost more in loss of operating efficiency than the protection given to the minority would be worth.

A more feasible way, perhaps, to guard against action causing termination of the election instigated by the majority either as corporate managers or as individuals is through use of a liquidated damage provision. Even though a shareholders' agreement prohibited all the acts that would cause termination of the election, still the equitable remedies of specific performance and injunction would not be effective, because there would be no way for the equity court to nullify retroactively an act that caused the termination. Moreover, damages for breach of such a shareholders' agreement would be virtually impossible to compute. For example, suppose a minority shareholder were in a 20% federal income tax bracket and the corporation would have to pay a 52% corporate tax in the event of termination of the election. Certainly termination in such a situation significantly increases the tax burden on the minority shareholder's share of the business profits. But this example over-simplifies the problems involved in measuring the injury to the minority shareholder. An accurate measure of damages would involve not only the current year but the indefinite future; and a number of factors would be involved, all highly speculative, including the

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[101] See text, *supra*, p. 216.

[102] See Roland Park Shopping Center, Inc. v. Hendler, 206 Md. 10, 14, 109 A. 2d 753 (1954).

[103] See *supra*, n. 13.

future incomes of the shareholder and the corporation, changes in the salary and distribution practices of the corporation, and changes in the tax law itself. In view of the difficulty of ascertaining damages, it would seem that a liquidated damage provision that sought to make a reasonable estimate of the damages would be sustained by the courts, and not held to be a penalty.[104] Of course, the parties would use such a provision in a shareholders' agreement not in the expectation that it would have to be invoked, but in the hope that it would be a deterrent to acts terminating the election. With these thoughts in mind, a draft of a shareholders' agreement to establish a rule of unanimity for Subchapter S questions is presented below:[105]

> AGREEMENT made this .... day of ...., 1960, between Daniel Doe, Edward Engle, and Fred Frame (hereinafter referred to as the Stockholders), and Green, Inc., a Maryland corporation (hereinafter referred to as the Corporation).
>
> WHEREAS the Corporation has elected and the Stockholders have consented under Section 1372(a) of the Internal Revenue Code of 1954 to tax treatment under the provisions of Subchapter S of the Internal Revenue Code of 1954 (hereinafter referred to as Subchapter S); and
>
> WHEREAS the Stockholders desire that Subchapter S tax treatment should not be terminated except with the unanimous consent of the stockholders of the Corporation;
>
> NOW THEREFORE, it is mutually agreed as follows:
>
> 1. (Same as section 1 of agreement on page 220)
> 2. (Same as section 2 of agreement on page 220)
> 3. (Same as section 3 of agreement on page 221)
> 4. No party hereto, either in his individual capacity, or as director, officer, or employee of the Corporation, shall do, vote for, or assent to any act causing the termination of Subchapter S tax treatment, unless there is unanimous stockholder approval of such act and termination. The failure to take action, reasonable in the circumstances, that would have prevented a

[104] See RESTATEMENT OF CONTRACTS (1932), § 339; MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES (1935), Ch. 24.
[105] See *supra*, n. 84.

termination of Subchapter S tax treatment shall be deemed assent to an act causing termination within the meaning of the preceding sentence.[106]

5. Inasmuch as the remedy at law would be inadequate and inasmuch as it would be extremely difficult to determine the actual damages resulting to parties hereto should Subchapter S tax treatment be terminated without unanimous consent of the stockholders, any party hereto who fails to comply with the terms of this agreement where such failure results in termination of Subchapter S tax treatment hereby agrees to pay to each of those stockholders of the Corporation who are not in default under this agreement (hereinafter referred to as complying stockholders) as liquidated damages ten dollars ($10) times the number of shares then owned by each such complying stockholder. If more than one party hereto fails to comply with the terms of this agreement and thereby contributes to the improper termination of Subchapter S tax treatment, all such defaulting parties shall be jointly and severally liable for the amount of liquidated damages above specified. As between themselves, such defaulting parties shall contribute to the satisfaction of such liability in proportion to the maximum number of shares owned by each during the six months period preceding the default.[107]

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[106] Under this clause breach of the agreement results from acts of a party taken in a corporate capacity as well as in an individual capacity, and also from a failure to act to prevent termination in either capacities. Thus, assenting to a failure of the corporation to exercise its option to purchase stock when a transfer would result in termination, or negligently allowing the corporation to exceed the 20% limit on personal holding company type income would be conduct constituting a breach of the agreement.

[107] As an illustration of how this clause is meant to operate, assume A, B, C, and D own 100 shares each in a Subchapter S corporation. B transfers his 100 shares to E, and E fails to consent to the election. A and B are directors and they fail to cause the corporation to exercise its right to purchase B's shares. A, B, and E would be "defaulting parties" under this clause, while C and D would be "complying stockholders". C and D would be entitled to liquidated damages of $1,000 each. A, B, and E would each be liable for the full $2,000 in damages, and would each contribute $666.67 to the satisfaction of the liability. The $2,000 damage figure is, admittedly, only a rough attempt to compensate the complying stockholders for their loss resulting from termination of the election. In working out a proper measure of damages, the chief factor is the difference between a stockholder's individual tax rate and the corporate tax rate. But even this is just a beginning, for many imponderables are involved, such as the length of time the corporation will be foreclosed from re-electing Subchapter S tax treatment, the future changes in both the corporate and individual tax rates, the future dividend policy of the corporation, and the possibility of eventual liquidation. The formula used makes no attempt to relate the amount of damages due each complying stockholder to his individual tax situation, for the complexities are too formidable. One way to arrive at a

6. (Same as section 8 of agreement on page 222)

IN WITNESS WHEREOF, we, the undersigned, have executed and sealed this agreement.

CONCLUSION

The enactment of Subchapter S, presumably with the best of intentions to aid small businesses with their tax problems, has, it is true, given the tax planner a helpful new tool to use in certain relatively rare situations. But it has also created a myriad of opportunities for abuse and a host of difficult problems for the lawyer who seeks to mold the relationships of the business owners so that they can live peaceably within the framework of this new creature, the Subchapter S corporation.

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dollar amount per share to be used in the formula is to ascertain the difference between the average tax bracket of stockholders and the average tax bracket of the corporation, and then multiply this difference (expressed in terms of percentage) by the dollar value of a share of stock. For example, if the average individual tax bracket were 30% and the average corporate tax bracket were 50%, the corporate business income would be worth 20% less to the average stockholder after termination of the election than before; consequently his damage is roughly 20% of the value of his stock. If, in this instance, the stock was worth $50 a share on the eve of the execution of the agreement, liquidated damages of 20% times $50, *i.e.*, $10 per share, would be a suitable measure of damages to use. This liquidated damage clause is, admittedly, a monstrosity, but at least it indicates one possible approach to a very difficult problem.