Election, Operation and Termination of a Subchapter S Corporation

Ronald R. Hrusoff
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By Ronald R. Hrusoff†

I. INTRODUCTION

ECONOMISTS AND BUSINESS writers have complained about the unfairness of the corporate income tax for years. Generally, their cries have gone unheeded. In a half-hearted attempt to remedy the problem and to ease the tax burden on the small businessman, President Eisenhower recommended in his 1953 budget message to Congress:

Small business should be able to operate under whatever form of organization is desired for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.1

The President’s enthusiasm was not shared by all factions of Congress. His proposal was rejected completely by the House Ways and Means Committee;2 however, the Senate drafted rather elaborate provisions covering both corporations and partnerships. All but that portion covering partnerships wishing to be taxed as corporations3 was killed in conference.4 The 1954 provisions,5 received little enthusiasm from the tax bar. Three years later, while considering the technical

1. Eisenhower, 1953 Budget Message to the 83d Cong., Tax Recommendation number 16, January 1953. Mellon, when he was Secretary of the Treasury, made a similar recommendation in 1927. PAUL, TAXATION IN THE UNITED STATES 140 (1954).
amendments to the 1954 Code, the House suggested the partnership provisions be repealed. The Senate Finance Committee not only disagreed but offered a re-drafted version of the previously-rejected corporations-taxed-as-partnerships provisions. The Senate managers prevailed in conference, and what is now Subchapter S came into being as part of the 1958 Technical Amendments Act.

A wave of criticism followed. Mortimer Caplin, Professor Anthoine and the editors of Mertens suggested the section should be repealed. One writer compared this provision to a fish lure; he concluded the taxpayer, like the fish, would end up in hot water. Another told us “The writer of the old serial, 'The Perils of Pauline,' was a piker in fabricating perilous situations when compared with those which the authors of the tax law manufacture for the tax lawyer.” Nevertheless, six years have passed, the section has been thrice amended, and at least 100,000 elections have been made under it. It would seem that Subchapter S is here to stay.

Although most businesses will find it more profitable not to elect or to remain in the partnership form, an election may profitably be made in at least four situations. They are:

7. S. Rep. No. 1983, 85th Cong., 2d Sess. 87-89, 216-26 (1958). “... the enactment of a provision of this type is desirable because it permits business to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence.” Id. at 87.
12. Anthoine, Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment, 58 COLUM. L. Rev. 1146, 1175 (1958) “... subchapter S is bound to be a 'gimmick' section.”
13. 7 MERTENS, LAW OF FEDERAL INCOME TAXATION § 41B.44 (1962).
18. Lourie, Subchapter S After Three Years of Operation, 18 TAX L. REv. 99 (1962) believes in “a large number of situations, factors other than considerations of federal income tax consequences deprive individuals of a free choice of business form” Moore & Sorlien, supra note 8 at 459 express the belief that an election should only be made if one of the following three reasons exists:
   (1) If the business is a truly small one, with comparatively steady income anticipated and stockholders who do not have substantial outside income;
   (2) If stockholders have substantial outside income, and a sizeable loss for the year is anticipated;
   (3) If sophisticated, competently advised stockholders wish to take advantage of one of the 'gimmicks' allowed, probably unintentionally, by Congress.
(1) A partnership electing to receive corporate benefits;

(2) A corporation electing to prevent excessive salaries from being disallowed as a business expense;

(3) A corporation electing to take advantage of lower individual rates; 20

(4) A corporation electing before liquidating or selling certain assets.

A partnership — if it may continue to be taxed as one — may wish to incorporate to obtain certain corporate benefits. Once it is incorporated, the shareholder-employees may participate in qualified pension, profit sharing, stock bonus, 21 or group life insurance plans, 22 and the heirs may receive up to $5,000 in death benefits. 23 These benefits, when closely analyzed in the light of recent amendments (which have either extended them to non-corporate employers or have destroyed them) 24 turn out to be largely of peripheral value. The grief accompanying a change from a partnership to a corporation may not equal the anticipated benefits. The limited value gained from incorporating a partnership has accounted for much of the criticism of Subchapter S. 25

The second and third situations are the reverse of each other. Weaver Airline Personnel School, Inc. v. Bookwalter 26 illustrates the second. In that case taxpayers had invested less than $15,000 in a corporation that operated an airline employees training school. Each owner was drawing a salary in excess of $92,000 within five years.

20. With the recent reduction of the normal rate (tax on first $25,000 of profit) from 30 to 22 per cent this reason loses much of its appeal. § 11(2).

21. § 401.

22. §§ 105–06.


24. § 401. As the 1962 amendments to section 401(c) allow self-employed to participate in this program it is no longer as desirable as it once was to incorporate for the "fringe benefits." For an extremely good article on the 1958 version of the bill see Rapp, The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keough Bill, 14 Tax L. Rev. 55 (1958); see also Caplin, Income Tax Pressures on the Form of Business Organization: Is it Time for a "Doing Business" Tax?, 47 Va. L. Rev. 249, 251–52 (1961).

25. Caplin, supra note 11; Mulhern, Executive Compensation and Fringe Benefits, 40 Taxes 943 (1962); Willis, supra note 14. The problems arising under the restrictive application of § 1361(d), United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), and the Service’s inartistically drafted regulations attempting to restrict the various corporate benefits to bona fide corporations (Treas. Reg. § 301.7701–2 (1965)) are beyond the scope of this article.

To avoid a portion of their salary from being taxed first as corporate profit and then as a dividend, the corporation elected to be taxed under Subchapter S. The district court agreed that this election was highly proper, for: "This subchapter permits small business corporations, who qualify, to elect to be taxed, in effect, as partnerships. Under such an election the reasonableness of salaries paid to stockholders is not an issue."27 As the 1964 income averaging provisions made no mention of electing shareholders,28 it would seem that an election could be coupled with income averaging to spread earnings over a greater period. While the new provisions are fairly restrictive they do allow savings in extreme cases.29

27. Id. at 602; Lourie, supra note 18 at 104.
29. § 1301 provides in part "If an eligible individual has averagable income for the computation year, and if the amount of such income exceeds $3,000, then the tax imposed by section 1 for the computation year which is attributable to averagable income shall be 5 times the increase in tax under such section which would result from adding 20 percent of such income to the sum of — (1) 133 1/3 percent of average base period income. . ." Algebraically expressed:

\[
(y_1, \text{ thru } y_4, \text{ represent the previous 4 years, } y_5 \text{ the present year}) \\
1.33 \left( \frac{y_1 + y_2 + y_3 + y_4}{4} \right) = x \\
\]

\[
a = y_5 - x \\
.: \; x + 2a = \text{ tentative taxable income} \\
i = \text{ total tentative tax liability} \\
i_i = \text{ tax liability on } x \\
i - i_i = \text{ tax liability of .2 of the averagable income} \\
5(i - i_i) = \text{ tax on total averagable income} \\
5(i - i_i) + i_i = \text{ total final tax liability} \\
\]

For most taxpayers . . . the application of this averaging provision is relatively simple. This can be illustrated by an example of an unmarried taxpayer having an average base period income of $3,000 in the years 1961-64 and an adjusted taxable income of $44,000 in 1965. The taxpayer in this case is eligible for averaging since his 'averagable income' exceeds $3,000. . .

Since the averagable income is in excess of $3,000, the entire amount is subject to averaging.

Computation of tax:

(a) 133 1/3 percent of average base income ($3,000 \times 133 1/3 percent) $4,000
(b) Averagable income included in tentative tax base (3% of $40,000) 8,000
(c) Tentative taxable income. 12,000
(d) Total tentative tax liability (1965 rates under bill) 2,830
(e) Tax on $4,000 not subject to averaging 690
(f) Tax liability on 3% of averagable income 2,140
(g) Tax on total averagable income ($2,140 \times 5) 10,700
(h) Total final tax liability (tax on $4,000 not subject to averaging and $40,000 subject to averaging) 11,390
(i) Tax on $44,000 under 1965 rates without averaging 18,990

If a more realistic example is used it becomes evident that this section only allows savings in very exceptional circumstances. Assume a base income (four year 1961-64
The 1958 Senate Report described the third situation in the following terms:

... [this provision] 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.

The owner does not need to leave the earnings in the business, as suggested, to profit under this section. All that is required is a corporation with limited earnings and an owner with little or no income except what he receives as dividends from the corporation. Of course, if he can take his profit out as salary this provision is inapplicable to him. A new venture, especially if initial losses are expected, might begin operation as an electing corporation and then losses that might otherwise be lost can be passed on to the owners and deducted from their gross income. When the corporation turns the corner and begins to show a profit, the election may easily be revoked or terminated.

The fourth situation involves “one shot affairs.” The election is made to accomplish a specific task; the election is terminated when the task is completed. For example, a corporation with three or four rich shareholders and with substantial retained earnings may wish to elect if it anticipates a loss year. Normally the loss would only be reflected as a reduction in the corporation’s earnings and profits account, which may or may not affect future distributions. If the firm is subsequently liquidated, any benefit derived from operating losses has effectively been converted from the income to the capital account. But if the firm elected to be taxed as a Subchapter S corpo-

average) of $10,000 and an adjusted income of $15,000 in 1965. The tax would work out as follows:

(a) 133 1/3 percent of average base income ($10,000 x 133 1/3 percent) $13,300
(b) Averagable income included in tentative tax base (3% of $1,700) 340
(c) Tentative taxable income ............................................. 13,640
(d) Total tentative tax liability (1965 rates under bill) ................. 3,420
(e) Tax on $13,300 not subject to averaging ................................... 3,298
(f) Tax liability on 3% of averagable income ............................ 122
(g) Tax on total averagable income ($122 x 5) ......................... 610
(h) Total final tax liability (tax on $13,300 not subject to averaging and $1,700 subject to averaging) ................. 3,908
(i) Tax on $15,000 under 1965 rates without averaging .............. 3,940

Thus, it can be seen that an increase of better than 50 percent must be realized before the taxpayer benefits from income averaging — at least at the lower rates. See Goldberg, Income Averaging under the Revenue Act of 1964, 74 YALE L.J. 450, 470-75 (1965); Schneider, Many Problems under Income Averaging, 22 J. TAXATION 44 (1965).

31. § 1374(a).
32. § 1372(e) (2).
33. § 1372(e) (1); Treas. Reg. § 1.1372-4(b) (3) (1960).
ration, the loss could be saved. It would be passed directly on to the shareholders and could be offset against their ordinary income. Subchapter S may also be beneficially used if the firm is about to sell a portion of its assets at a capital gain. Normally the corporation would be tapped for a capital gains tax, and then the stockholder would be hit when the proceeds are distributed as dividends — this time at regular income rates. By electing before the sale, the only tax will be a capital gains tax imposed on the shareholders. One point should be handled with care. While the corporation can terminate the election with ease, without the necessity of showing a business purpose (even though it knew termination, and possibly liquidation, was imminent when it elected), the termination will be carefully scrutinized. Revocation is a bit more difficult for it requires unanimous consent and will not go into effect until the following year. However these requirements are not burdensome in many cases.

Sales after election may profitably be made in a great variety of situations. They will be discussed in detail in Section III. It is sufficient, at this juncture, to note that the flexibility with which “one shot affairs” may be handled is the most useful feature of Subchapter S.

Corporate owners, partners, or proprietors should reflect at considerable length on the relative merits of each business form before an election is attempted. While Subchapter S offers various advantages, it imposes disadvantages as well. The electing partnership loses administrative flexibility and becomes subject to state corporate income taxes. The corporation may be reinvesting all its earnings and the owners may plan to eventually merge out or sell out. This course may yield the owners a larger return than anything possible under

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34. § 1374.
35. § 301(c) (1).
36. § 1375.
37. See infra and notes 45–61.
41. § 1372(e) (2).
42. § 1372(e) (2) (B); the revocation provisions have been criticized as “almost meaningless” because of the ease of termination. Note, Optional Taxation of Closely Held Corporations under the Technical Amendments Act of 1958, 72 HARV. L. REV. 710, 713 (1959).
44. See P.H. STATE TAX GUIDE 213 (1964) for a chart indicating the extent that various states follow the federal tax code. See also Kalupa, Subchapter S Election May Cause Increase in State Taxes, 10 J. TAXATION 137 (1959).
Subchapter S. Perhaps a banner year is expected. If so, it is of no advantage to be operating as a Subchapter S corporation; the flat corporate rate will be far lower than that of its owners.

II. ELECTION AND OPERATION

A. The Election

A partnership or corporation must meet a series of fairly simple mechanical tests to operate as a Subchapter S corporation. At the outset, a partnership or proprietorship must incorporate; Subchapter S is limited to domestic corporations which are not part of an affiliated group. The corporation must file form 2553 with the district director, and each shareholder must file a written consent to the election. In contrast to other portions of the Code, one holdout destroys the election. There must be less than eleven individual, non-alien shareholders. Although a husband and wife holding stock as community property, or as joint tenants, tenants by the entirety, or tenants in common are counted as one, not two shareholders, each must file written consent to the election. The corporation may not have more than one class of stock, derive more than 80 percent

45. § 1371(a).
48. § 333(c) (1); § 337(d); cf. § 1361(f).
50. § 1371(a)(1)(2).
51. § 1371(a)(3).
52. All shareholders must be individuals or estates. Corporations, partnerships, trusts or voting trusts are not permissible shareholders; nominees, agents, guardians, custodians or usufructs are. Treas. Regs. §§ 1.1371-1(d) (1), 1.1371-1(e) (1960) Rev. Rul. 64-249, 1964-2 CUM. BULL. 332. Care must be taken that the magic number 10 is not exceeded by a guardian holding stock for several beneficiaries. The beneficiary, not the guardian, is considered the shareholder. Treas. Reg. § 1.1371-1(d) (1960).
53. § 1371(c)(1).
54. § 1371(c)(2).
56. § 1371(a)(4). This does not mean merely that the corporation may not issue preferred and common; it may not issue two types of common. “Thus, a difference as to voting rights, dividend rights, or liquidation preferences will disqualify a corporation. . . . if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.” Treas. Reg. § 1.1371-1(g) (1960). The election will also be lost if one shareholder gives another an irrevocable proxy, as this will create voting and non-voting stock. Rev. Rul. 63-226, 1962-3 CUM. BULL. 341; cf. Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964); See Weinstein, Stockholder Agreements and Subchapter S Corporations, 19 TAX L. REV. 391 (1964).
of its gross receipts from sources outside the United States, nor receive more than 20 percent of its income "from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities." The election is terminated automatically if any of these conditions are not met. The only penalty suffered is that the corporation may not make a new election for five years — but for good cause, the Commissioner may waive this requirement.

The incorporation of a partnership normally is tax-free. Only two simple conditions must be met: the partners must receive 80 percent of the stock, and the corporation may not exchange any stock or securities for services "rendered or to be rendered." The corporation takes the partnership's basis for the property transferred to it. When the incorporation is carried on by wealthy individuals under the guidance of a tax attorney, the incorporation generally serves, and rightly so, as an occasion to rearrange the firm's assets. The "normal" situation vanishes; the "normal" tax problems appear.

If at all possible, the exchange should be an occasion for removing capital from the business. If left with the firm, it will be capitalized and locked in. As the partners have already included earnings and profits on their tax returns, all earnings may be removed tax-free. Earnings represented by cash and accounts receivable present no problem; they simply are not transferred from the partnership to the corporation. Often earnings are tied up in fixed assets, or the business cannot function if cash is removed. Here a storm of problems blows up. Taxpayers have attempted — without much success — to get cash out by several methods. One method was to strip the corporation of all cash, and then prior to transfer, mortgage the assets or sell and lease back some property. After transfer the

The Commissioner grudgingly agreed that stock issued to the Federal Housing Commissioner as required by 24 C.F.R. § 207.18(c) will not terminate the election. Rev. Rul. 64-309, 1962-4 CUM. BULL. 333. 57. § 1372(e)(4).

58. § 1372(e)(5); see United States v. 525 Co., 342 F.2d 759 (5th Cir. 1965) for an illustration of the Commissioner's eagerness to seize on the smallest technical point in an attempt to force a termination of the election.

59. §§ 1372(e)(1), 1372(e)(4), 1372(e)(5).

60. § 1372(f).


62. § 351(a).

63. § 368(c). Actually the partners need not receive 80 percent of the stock; all that is required is that the persons contributing property compositely receive 80 percent of the stock. Treas. Reg. § 1.351-1 (1955).

64. Treas. Reg. § 1.351-1(a)(1) (1955). If a person donates both property and services the court will apportion the value of each and only allow tax-free treatment to that portion representing the property interest. United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964); cf. James C. Hamrick, 43 T.C. 21, 34-35 (1964); see Hertz, Allocation of Stock between Services and Capital in the Organization of a Closed Corporation, 75 HARV. L. REV. 1098 (1962).

65. § 358(a).
corporation would borrow working capital from its stockholders or from a commercial lending institution — perhaps with its notes guaranteed by the shareholders. As an alternative to draining the corporation of cash, the owners would take back stock and securities, rather than just stock, from the corporation. The corporation would then redeem the securities at its convenience. These tactics have all been attacked. Section 357(a) allows the corporation to assume outstanding debt along with assets it receives. However, if it is found that placing the debt on the assets was part of a plan to avoid income taxes or served no business purpose, the assumption of the partner’s debt will be considered money received by him on the exchange and will be taxed to him as a dividend. The debt will be taxed to him as a dividend. Section 357(c) imposes a further qualification. If the sum of the liabilities exceeds the basis of the property transferred, the excess is treated as gain. This provision prevents cash from being taken out through the device of a “quickie” mortgage. A sale and lease-back will occasion a capital gains tax on the excess of the sale price over basis, turning a tax-free exchange into a taxable occasion. Borrowing capital or issuing debt instruments to the shareholders may not be found to be debts at all, but in fact equity. The corporation then is said to be “thinly-incorporated.” A “thinly-incorporated” firm’s deduction for debt interest will be disallowed. Any redemptions will be treated as dividends or as a return of capital depending on the state of the earnings and profits account. The regulations provide even harsher treatment for a Subchapter S corporation. “If an instrument purporting to be a debt obligation . . . [is found to be stock] it will constitute a second class of stock” and the election will be terminated. This provision is without direct support in the Code; for this reason it

66. § 357(b) (1) (A).
67. § 357(b) (1) (B).
68. § 357(b); see BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 86-89 (1959).
69. § 301 (b) (1) (A).
72. Treas. Reg. § 1.1371-1 (g) (1960). Immediately after Subchapter S was enacted Manly (Election under Subchapter S Can Eliminate Thin Incorporation Problems, 8 J. TAXATION 322, 323 (1958)) expressed the view that securities found to be equity should not be deemed a second class of stock; they should merely be added to the equity account. By failing to take this approach another stumbling block was added to the election process.
73. § 1371(a) (4).
74. Compare § 1371(a) (4) “... 'small business corporation' means a domestic corporation ... which does not ... have more than one class of stock” with Treas. Reg. § 1.1371-1 (g) (1960) “If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.”
has been criticized by the commentators\textsuperscript{75} and the Tax Court.\textsuperscript{76} Put to a direct test it would not come as a surprise if the courts declared this section invalid and applied the same standards to Subchapter S corporations as they do to all other corporations.

The early cases dealing with “thin-incorporations” were principally concerned with taxpayers’ attempts to put equity capital into the firm under the guise of bonded indebtedness. These instruments attempted to straddle the line between equity and debt. During the late 1930’s and the early 1940’s, a number of corporations came out of reorganizations with some type of hybrid security included in their capital structure. Generally they provided that interest need be paid only if earned. With these instruments in mind it seemed reasonable that a company could issue similar securities at its inception. The courts had little difficulty distinguishing the bona fide reorganization issue from the “tax-avoidance special.” The latter was always disallowed.\textsuperscript{77}

Taxpayers turned from this rebuke to true “thin-incorporations.” While the typical manufacturer has 30 or 40 percent of his capital structure represented by debt, and a well-managed utility may have as much as 60 percent, firms were being incorporated with 80, 90 or 95 percent debt. From 1946\textsuperscript{78} until the mid 1950’s, high debt ratios were frequently challenged.\textsuperscript{79} Little consideration was given to other factors during this period. After the 6th Circuit decided \textit{Gooding v. Commissioner}\textsuperscript{80} in 1956, the courts have begun to look at subjective factors. Cases are examined today that would have been off-handedly

\textsuperscript{75} Supra notes 11-15.

\textsuperscript{76} Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1366 (1964).

\textsuperscript{77} John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); compare Commissioner v. Schmoll Fils Associated, Inc., 110 F.2d 611 (2d Cir. 1940) with Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935). For an extensive discussion of this group of cases see Weis, \textit{The Labyrinth of the Thin Corporation}, 40 TAXES 568, 570-71 (1962); see generally, Bittker, \textit{op. cit. supra}, note 68 at 113-17. This problem is not unique to the debt-equity situation. Cf. Morrissey v. Commissioner, 296 U.S. 344 (1935) (attempt to straddle the line between a corporation and a partnership); Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963) (association — taxed as a corporation, partnership or employee-employer relationship); Commissioner v. North Am. Bond, 122 F.2d 545 (2d Cir. 1941), \textit{cert. denied}, 314 U.S. 70 (1942); Commissioner v. Chase Nat'l Bank, 122 F.2d 540 (2d Cir. 1941) (trust or association). See Weis, \textit{supra}, note 77 at 578-80.

\textsuperscript{78} 326 U.S. 521 (1946). The courts began to think in terms of debt ratios after Mr. Justice Reed stated: “As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.” \textit{Id.} at 526.

\textsuperscript{79} The Tax Court finally determined that a ratio of 3½ to 1 was acceptable, Ruspyn Corp., 15 T.C. 769 (1952), acq., 1952-1 CUM. BULL. 3; in all subsequent cases it refused to find illegality if the taxpayer kept the ratio below 4 to 1. The Fifth Circuit rejected the debt-equity approach and looked instead to the taxpayer’s intent: of necessity, it examined a variety of circumstances. Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955); Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955). See Weis, \textit{supra}, note 77 at 578-80.

accepted or rejected a few years ago. The courts have developed a multitude of tests generally to be read together — to determine whether they should allow any given capital structure. By doing so they are in the main stream of American jurisprudence and are approaching the problem in the same manner in which they have dealt with antitrust or licensing cases. Perhaps fairness has been promoted. However, in a merger case, the effect on the national market, the local market, suppliers, consumers and competitors, or in a "thin-incorporation" proceeding, the question whether the company had sufficient earnings to pay off the debt when due, had a sinking fund, or borrowed additional operating capital destroys both workability and predictability. For this reason both the antitrust and the tax bars have pushed for definite standards. The Advisory Group to the Mills Committee and the American Law Institute recommended that

82. Motel Co. v. Commissioner, 340 F.2d 445, 446 (2d Cir. 1965); Judge Medina in Gilbert v. Commissioner, 248 F.2d 399, 406 (2d Cir. 1957) pointed out that the courts have stressed:
One or more of a number of factors, including the debt-equity ratio, the presence of an agreement to maintain proportionality between the advances in question and acknowledged risk capital, the presence of tax avoidance motives, the use to which the funds were put, whether outside investors would make such advances, and lack of reasonable expectation of repayment.

In his opinion the most important factor seemed to be the probability of repayment, for "Congress evidently meant the significant factor to be whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture. ..." Id. at 406. See also ALI, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 400-37 (1958).


84. WORZ v. FCC, 323 F.2d 618 (D.C. Cir. 1963), cert. denied, 376 U.S. 914 (1964); Community Telecasting Corp. v. FCC, 317 F.2d 592 (D.C. Cir. 1963); Tampa Times Co. v. FCC, 230 F.2d 224 (D.C. Cir. 1956); Scripps-Howard Radio, Inc. v. FCC, 189 F.2d 677 (D.C. Cir.), cert. denied, 342 U.S. 830 (1951). In District of Columbia v. G.M., 336 F.2d 885 (D.C. Cir. 1964) the Court of Appeals applied a single test, rather than looking to a three-pronged test to determine local franchise taxes; the Supreme Court, in turn, was quick to grant certiorari and reverse, 380 U.S. 553 (1965).


any debt ratio lower than 5 to 1 be acceptable. Their recommendations have gone for naught.

As a practical matter, the Subchapter S corporation, having so much to lose, would be well advised to limit its debt ratio to 4 to 1 (80 percent debt) and to borrow from a commercial institution — even if the stockholders co-sign the corporation’s note. Mr. Justice Brennan, speaking for the Court in *Putnam v. Commissioner,* a case dealing with business losses instead of “thin-incorporations,” could see “no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same. . . .” Nevertheless a loan from a commercial lending institution is less likely to be attacked than one from the shareholders.

The Commissioner has recently attempted to use a § 351 transfer as a taxable occasion. Taking his cue from a series of cases decided under § 337, which held that bad debt reserves will be taxed as income when the property to which they are attached is sold, he applied this reasoning to § 351 transfers. The logic is a bit thin as to why bad debt reserves are not transferred with the accounts they protect. In practice they are deducted by the purchaser from the value of the property transferred. Thus, the purchase price has been reduced to compensate for anticipated uncollectible accounts. Rather than taxing the reserve as income, the Commissioner should add it to the purchase price and tax it as a capital gain. When this concept is applied to a § 351 exchange, it is no longer merely of questionable merit; it is absurd. The property has not been sold; all that has changed is the form under which the enterprise is operated. Why then should the reserve protecting an operating asset be destroyed? Nevertheless, the Tax Court in *Estate of Heinz Schmidt,* recently held that a proprietorship’s bad debt reserve became income at the moment the firm incorporated. It is doubtful if this decision will stand up on appeal. But if it does, one more hurdle will be added to effective usage of Subchapter S.

Any corporation desiring to elect may do so by following the procedure outlined in §§ 1371-72. In addition to the “thin-incorporation” problem common to corporations and partnerships alike, a

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89. 352 U.S. 82 (1956).
92. 42 T.C. 1130 (1964).
93. The corporation or partnership that does not increase its debt when electing will not have the problem that a firm adding debt has. This type of firm will have
corporation frequently has a second class of stock or certain non-acceptable assets\textsuperscript{94} which must be eliminated before an election may be made. Obviously the company may sell or distribute the forbidden fruit as a dividend. Either alternative rewards the tax collector with a share of the proceeds. In certain situations there may be a third choice. The corporation may spin-off the forbidden assets to a separate non-electing corporation prior to electing. The transfer will not be taxed if the spin-off and distribution of the second corporation's common stock to the original shareholders meets certain criteria.\textsuperscript{95} The shareholders of former corporation X will now have their interest divided into electing corporation X and non-electing corporation Y — formerly a part of X. The procedure to be followed is set out in § 355.

Section 355 allows the separation of two or more businesses formerly operated by a single corporation.\textsuperscript{96} The Code requires that each of the two businesses must have been in operation for over five years, and each must continue in operation after separation.\textsuperscript{97} The transaction must not be used as a device to distribute earnings and profits\textsuperscript{98} or have as one of its principal purposes the avoidance of income tax.\textsuperscript{99} A rather heavy coating of interpretive gloss has been spread over certain portions of § 355. The regulations have not merely amplified the Code; they have restricted its application. The result has been a great deal of litigation. Controversy has been confined largely to two areas: the first is the definitional question — what are two businesses; the second is prompted by the attempt to require a corporate business purpose behind all splits. Spin-offs by corporations attempting to qualify for Subchapter S status naturally are affected by the interpretation of these regulations.

The regulations provide that "Section 355 does not apply to the division of a single business,"\textsuperscript{100} nor does it apply if either of the two separate activities do not form a complete business.\textsuperscript{101} A corporation

\textsuperscript{94} § 1372(e) (4) (more than 80 percent of its gross income from sources outside the United States); § 1372(e) (5) (more than 20 percent of its gross receipts from royalties, rents, dividends, interest, annuities or gain from sales of securities).


\textsuperscript{96} § 355(a) (1).

\textsuperscript{97} §§ 355(b) (2) (A), 355(b) (2) (B); Curtis v. United States, 336 F.2d 714 (6th Cir. 1964). However, the new corporation may carry on a different business with the assets received. Becher v. Commissioner, 221 F.2d 252, 253 (2d Cir. 1955); Pebble Springs Distilling Co., 23 T.C. 196, 201 (1954), aff’d, 231 F.2d 288 (7th Cir.), cert. denied, 352 U.S. 836 (1956).

\textsuperscript{98} § 355(a) (1) (B).

\textsuperscript{99} § 355(a) (1) (D) (ii).

\textsuperscript{100} Treas. Reg. § 1.355–1(a) (1956).

\textsuperscript{101} Treas. Reg. §§ 1.355–1(c), 1.355–1(d) (examples 8, 10–16) (1956).
owning securities, land, or a building (even if partially rented out) may not classify this ownership as a separate business. The Code gives no indication that Congress intended restrictions of this nature to be imposed. It only requires the distributing corporation and the corporation to be “engaged immediately after the distribution in the active conduct of a trade or business.” Although it probably is too early to tell, it appears that only half of the Treasury’s regulations will stick.

The Tax Court in Edmund P. Coady affirmed on appeal by the Sixth Circuit, and the Fifth Circuit in Marett v. United States invalidated that portion of the regulation reading: “Section 355 does not apply to the division of a single business.” These courts found this provision unduly restrictive and lacking support in the statute or the legislative history. The Commissioner not only refused to acquiesce in Coady but continued to press his view. In Patricia W. Burke, the taxpayer first opened a branch store, then spun it off to a separate corporation. The denial of § 355 status was reversed by the Tax Court. At this point the Commissioner capitulated.

It is only one step from Coady to the holding that a company may split itself vertically as well as horizontally. If a company with two clothing stores may split them into two separate corporations, what prevents a dairy operating an ice-cream parlor from separating its activities? Logically, nothing. While no cases seem to be directly on point, two recent Tax Court decisions indicate that that body would rule against the Commissioner if the issue were squarely presented. A state and national bank merged in Mary A. Morris Trust. Prior to the merger the state bank carried on an insurance business which it was required to end. The Commissioner refused to sanction a tax-free § 355 spin-off because this was not a separate business, but an integral part of the state bank’s operation. The Tax Court merely ruled that this was in fact a separate business; by doing so it did...
not need to reach the question whether a vertical separation will qualify for § 355 treatment. *Marne S. Wilson*\(^{114}\) is a similar case. The taxpayer's principal line of business was a furniture store; as a sideline he conducted his own credit financing. As his business grew, the credit operation became more and more demanding, until it became expedient to place the credit operation in a separate corporation. A § 355 transfer was used. The Tax Court again ruled against the Commissioner declaring this transfer to be a correct application of § 355. In neither instance could the adjunct operation stand alone. In both cases the major and minor activity was conducted on the same premises largely by the same personnel. In both, the principal business provided the majority of the minor operation's customers. The *Mary Morris Trust* and *Wilson* decisions certainly water down, if not fly in the face of, the requirement that a

... business consists ... of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning profit from such group.\(^{115}\)

The Tax Court may intend to find "separate businesses" — even where others have difficulty separating them — rather than directly attacking the regulations.

The third group of restrictions has been maintained. The Service has been singularly successful in preventing companies owning land, securities, or buildings\(^ {116} \) from obtaining the benefits of § 355 when they spin-off this type of property. The first time the Tax Court considered these provisions it concluded:

... a mere passive receipt of income from the use of property which is used in the principal trade or business and which is only incidental to, or an incidental use of a part of property used primarily in, the principal business would constitute the active conduct of a trade or business within the meaning of section 355(b), ...\(^ {117}\)

It applied this doctrine two years later in *Theodore F. Appleby*,\(^ {118} \) a case where the business spun-off a building it had partially occupied and partially rented out. The Tax Court found that the rental activities did not constitute a separate business but were only incidental to

\(^{114}\) 42 T.C. 914 (1964).
\(^{115}\) Treas. Reg. § 1.355-1(c) (1956).
\(^{116}\) Treas. Reg. § 1.355-1(c)(1)-(2) (1956).
\(^{117}\) Isabel A. Elliott, 32 T.C. 283, 290 (1959).
the taxpayer's principal business. It might be noted, by way of passing, that the Tax Court is applying an extremely strict standard. In *Appleby* 50 percent of the floor space and 30 percent of the rental value of the building was leased.\(^{110}\) The Second Circuit attempted to supply the rationale for blocking realty distributions while at the same time allowing single business split-ups or vertical spin-offs. It is reported in *Bonsall v. Commissioner*\(^{120}\) that

\[\text{[t]he possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building. Under taxpayer's interpretation, all that need be done is to transfer the building to a new corporation and distribute the stock received in return. The shareholders would then be free to sell their stock and pay a capital gains rate on the proceeds while the corporation can rent or purchase another building and reduce its accumulated earnings.}\(^{121}\)

Any corporation considering an election will be guided of necessity by these holdings. It seems the company could spin-off foreign operations\(^{122}\) or could transfer a group of stores to non-consenting shareholders. Either transaction would qualify under the "single business" exception as interpreted by *Coady*. However, *Bonsall* prevents a firm from ridding itself of sufficient securities or real estate to reduce its income from this source below 20 percent of total income.\(^{123}\) A firm with holding-company income is effectively prevented from electing unless its shareholders stand ready to bear an immediate tax on the distribution of the holding company assets. As a practical matter the company should dispose of all holding company assets before it elects to be taxed under Subchapter S. If any holding company property is kept, the possibility always exists that the corporation will experience a loss year while receiving holding company income. Should this happen the election will be terminated and the loss may be foregone.\(^{124}\)

It is unfortunate that the Treasury proposed and Congress enacted the holding company exception as part of the Small Business Act.

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119. *Id.* at 763.
120. 317 F.2d 61 (2d Cir. 1963).
121. *Id.* at 65.
122. § 1372(e) (4); as the corporation may receive as much as 80 percent of its income from sources outside the United States this exception is of little value.
123. § 1372(e) (5).
124. This in fact occurred in Temple N. Joyce, 42 T.C. 628 (1964). In 1959 the Farmingdale Corporation, a Subchapter S corporation, reported an operating loss of $211,270 and a gain of $1,947 from the sale of certain securities it held. Since the gain on the sale of the 1,000 shares constituted personal holding company income and amounted to more than 20 percent of the total gross receipts of Farmingdale, the election was terminated. *Id.* at 637-38. This slip-up cost the taxpayer approximately $46,000; see also J. William Frentz, 44 T.C. No. 43 (1965).
By doing so Congress is working at cross-purposes with itself. On one hand it struggles to prevent individuals from insulating their income through the corporate form. On the other hand it prevents a corporation having this type of income from electing to be taxed as an individual. Including holding companies under Subchapter S would benefit the Treasury. It would collect the individual rates it has been striving for years to obtain, while the taxpayer at the same time could obtain a degree of limited liability. From time to time commentators have discussed this conflict of purpose, but Congress to date has paid them no heed.

Gregory v. Helvering laid down the general principle that every transaction must not only comply strictly with the provisions of the Code but must also have a "business purpose." This requirement was written into section 1.355-2(c) of the regulations:

The distribution by a corporation of stock or securities of a controlled corporation to its shareholders ... will not qualify under section 355 where carried out for purposes not germane to the business of the corporations.

Taxpayers have attacked this section from various directions. It has been urged that "business purpose" includes the shareholders' business. This would be to say that any purpose not having as its principal goal the avoidance of federal income tax would be acceptable. The older cases, typified by Adams v. Commissioner and Bazley v. Commissioner, rejected this view and limited "business purpose" to corporate business. Recent cases, or perhaps merely the First, Second and Eighth Circuits as contrasted with the Tax Court...

127. This test is imposed by various sections of the Code. See §§ 302(c)(2)(B), 306(b)(4), 355(a)(1)(D)(ii), 357(b). See also Subchapter C Advisory Group Revised Report:

It is further provided in section 355(a)(1)(B)(ii) of the proposed revision that even though the transaction does not otherwise qualify under section 355 because of failure to satisfy the active business requirements or the 20 percent distribution requirement, it will nevertheless qualify under 355 if it is established to the satisfaction of the Secretary that the distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Id. at 65.
129. 331 U.S. 737 (1947).
130. Lewis v. Commissioner, 176 F.2d 646, 649-50 (1st Cir. 1949).
131. Estate of Parshelsky v. Commissioner, 303 F.2d 14, 17-21 (2d Cir. 1962).
and the Third, Fourth, and Seventh Circuits, have not limited "business purpose" to the corporation's business. Chief Judge Lumbard, speaking for a unanimous panel in *Parshelsky's Estate v. Commissioner*, the most recent decision, is of the opinion that most of the more recent cases have rejected the corporate business limitation "in favor of an evaluation of all the non-tax-avoidance motives of both the corporations and shareholders involved." If we may refer back for a moment to the discussion of "thin-incorporations," it will be remembered that the courts have abandoned a debt-ratio test and now look to all pertinent factors. Therefore, the Second Circuit by substituting a flexible for an inflexible standard is applying the more modern approach. This view will probably prevail. Perhaps more importantly, there is a line of cases where the courts have refused to deny tax-free status to a reorganization when each corporation remained in existence and conducted a bona fide business even though it was difficult to find a business purpose at the time the split-up occurred.

If the liberal standard is the correct one, a spin-off which paves the way for an election should itself provide an ample business purpose. The courts probably would accept this justification. In the past they have been quick to side with the stockholders if they are not merely attempting to distribute the corporation's earnings under the guise of a reorganization. The underlying philosophy was expressed by the Tax Court in *Louis Willhouse, Jr.* "To pay the shareholders' personal obligations is not one of the transactions contemplated as the purpose of corporate reorganization." However the partition of real estate into separate parcels so each could be willed to a different legatee was found acceptable in one case. The incidental watering down of the common to enable a prospective manager to

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137. 303 F.2d 14 (2d Cir. 1962).
138. *Id.* at 18; see also Michaelson, "Business Purpose" and Tax-Free Reorganizations, 61 YALE L.J. 14, 31-33 (1952); Spear, "Corporate Business Purpose" in Reorganization, 3 TAX L. REV. 225, 242-43 (1948).
140. *See Roemle, Business Purpose and the Subchapter S Inspired Reorganization*, 58 MICH. L. REV. 531, 539 (1960); *Tarleau, Corporate Recapitalizations as Affected by the Adams and Bazley Cases*, 6 N.Y.U. INST. ON FED. TAX 266 (1948).
141. *Id.* at 363.
142. *Id.* at 368; *Ortmayer v. Commissioner*, 265 F.2d 848 (7th Cir. 1959); *Heady v. Commissioner*, 162 F.2d 699 (7th Cir. 1947).
buy in was favorably received in another.\textsuperscript{144} And decreasing the size of decedent’s estate, making gifts to children, perpetuation of family holdings or adding flexibility to the management of the property have at times been considered business purposes.\textsuperscript{145}

But even if the more strict rule is applied, a corporation’s attempt to qualify for an election should be considered a “business purpose.” The courts have found a corporate purpose when incompatible businesses were separated,\textsuperscript{146} a risky operation was isolated from the rest of the business,\textsuperscript{147} or an ultra vires activity was spun-off.\textsuperscript{148} However, many of these same courts have indicated a “business purpose” may not be required if each unit remains in operation after separation.\textsuperscript{149} Judge Learned Hand, for example, said of \textit{Gregory v. Helvering} “[h]ad they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.”\textsuperscript{150}

Finally, tax avoidance at the corporate level may be classified as having a “business purpose.” In \textit{Kraft Foods Co. v. Commissioner},\textsuperscript{151} Judge Waterman commented that “we do not think ... tax minimization is an improper object of corporate management. ...”

A split-off solely to allow the corporation to elect to be taxed under Subchapter S probably will not be blocked as lacking a business purpose. No earnings and profits are distributed and, in the majority of cases, no other taxable event is circumvented.

The corporation with more than one class of stock has a problem similar to the firm with holding company assets. It must somehow rid itself of the second class of stock; as long as it is outstanding, the corporation is ineligible to make an election. If the second class is preferred and is held by the owners of the common proportionally to their common interest, it may simply be cancelled, or converted into common.\textsuperscript{152} Neither alternative will occasion a tax. Only if the corporation redeems the preferred for cash will a tax be imposed. And the preferred’s basis limits the tax. Preferred originally issued as a tax-free dividend\textsuperscript{153} will be treated as a dividend to the extent that

\begin{itemize}
\item 144. Rena B. Farr, 24 T.C. 350 (1955).
\item 145. Cf. F. W. Drybrough, 42 T.C. 1029 (1964); Jack L. Easson, 33 T.C. 963 (1960); rev’d, 294 F.2d 653 (9th Cir. 1961).
\item 146. Riddlesbarger v. Commissioner, 200 F.2d 165 (7th Cir. 1952).
\item 148. Thomas Williams, 12 CCH Tax Ct. Mem. 186 (1953).
\item 149. Supra, note 139.
\item 150. Chrisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir.), cert. denied, 296 U.S. 641 (1935); cf. Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955) (new corporation carried on a different business with assets received).
\item 151. 232 F.2d 118, 128 (2d Cir. 1956).
\item 152. § 306(e) (1).
\item 153. § 305(a).
\end{itemize}
the corporation now has earnings and profits. One exception exists: if the redemption terminates the shareholder's interest in the corporation (due to a previous sale of the common) it will not be treated as a dividend. Instead it will be treated as part and parcel of the common. If the preferred was not issued as a common dividend, the tax will be limited to the difference between the basis and redemption.

B. The Operation

In a sense, the corporation is born anew when it files an election. Previous losses or accumulated earnings and profits will not affect nor be affected by, operations under Subchapter S. Cutting off accumulated pre-election earnings should not alter the determination to elect. However, the corporation with large operating losses is effectively blocked from electing if it has any short term profit potential. Even though the pre-election corporation has been divorced from the current entity, the Code still requires that the electing corporation's earnings and profits be determined. Shareholder income, in turn, is governed by the corporation's earnings.

(1) Earnings and Profits

A Subchapter S corporation computes earnings and profits in the same manner as other corporations except that the special deduction allowed partially tax-exempt interest is disallowed. Dividends from inter-corporate transfers, foreign corporations, and certain types of preferred stock are also disallowed. Tax-exempt income paid to a Subchapter S corporation loses its identity and is taxed to the shareholder as regular income. State taxes can also affect the earnings and profits. For example, the corporation allowed to deduct federal taxes from state corporate income taxes will lose this privilege when it elects.
On the last day of the electing corporation's year, the earnings and profits are computed and taxed as if they had been distributed.¹⁶⁵ It makes no difference, tax-wise, if all, half, or none of the earnings have been distributed. The person who is a shareholder on the last day is required to include in his gross income his share of the corporation's annual earnings.¹⁶⁶ Stock transferred in the waning days of the corporate year will be taxed to the transferree — even though he only holds title for one day — not the transferor.¹⁶⁷ This provision allows the transferor to receive the dividends while the transferee pays the tax. Thus, a certain amount of income splitting can be accomplished through a well-planned “giving” program. The principal owner of a Subchapter S corporation may give his “low-bracket” children a block of stock in December on which he received dividends in May. He received “high-bracket” income at “low-bracket” rates. For this reason, the Service is careful in insuring that the gift was bona fide. The regulations warn that the circumstances surrounding a transfer between members of a family will be closely scrutinized,¹⁶⁸ and if it is found that they do not reflect the value of services rendered to the corporation, or no gift was actually made,¹⁶⁹ the Commissioner may reallocate distributions among family members.¹⁷⁰

The novel feature of being taxed as a Subchapter S corporation is that today's earnings may be retained and then taken out tax-free in subsequent years, although one restriction has been imposed. Only those persons who were shareholders when the retained earnings were earned may subsequently draw them out on a tax-free basis. A stockholder may not sell his shares and then draw out the funds; he must retain at least one share.¹⁷¹ Nor may he transfer undistributed dividends. They are personal to him and may not be drawn upon by another.¹⁷² Moreover, if he sells all his shares and then repurchases one share, he loses, then regains the right to receive tax-free distributions.¹⁷³ This requirement is not unreasonable. Any other provision

¹⁶⁵. § 1373(b).
¹⁶⁶. Ibid.; however he cannot claim the dividend exclusion allowed by §§ 34, 37, or 116 except to the extent the corporation is distributing pre-election earnings. Treas. Reg. § 1.1373-2(a) (1960).
¹⁶⁸. Ibid.
¹⁶⁹. See Henry D. Durarte, 44 T.C. — No. 21 (1965). Elaborate standards have been imposed under the partnership provisions to insure bona fide gifts. It can be assumed these standards apply to Subchapter S corporations. Treas. Reg. § 1.704-1(c) (1964). The safest way to avoid the problem is to give the gift in the form of an irrevocable trust. See Treas. Reg. § 1.704-1(e) (vii) (1964).
¹⁷⁰. § 1375(c). See Plowden-Wardlaw, supra note 23, at 991.
¹⁷². Ibid.; even decedents' estates may not take out undistributed profits tax-free.
would allow earnings to be accumulated by "low-bracket" taxpayers, then sold to and drawn out, tax-free, by "high-bracket" individuals.

The basis is affected by retained earnings. Both cash distributions and distributions of property will reduce the basis, although the latter only affects earnings and profits to the extent that they have not been allocated to actual money distributions. The regulations have provided a three-tier distribution plan controlling basis:

(1) Earnings and profits of the taxable year are first allocated to the actual distributions of money.

(2) The excess is allocated ratably to the constructive distribution of undistributed taxable income and actual distributions of property and

(3) The remainder is available to be allocated to distributions in exchange for stock of the corporation such as distributions under sections 302 or 331.

Therefore, the corporation that annually distributes all earnings will not subject its shareholders to an income tax on property distributions. Finally, while a purchaser cannot draw out undistributed earnings, the seller's basis is passed on to him.

(2) Operating Losses

Operating losses are passed directly on to the shareholders where they may be deducted from the current year's personal income. A corporation that is being liquidated may still elect and pass its operating losses on to its shareholders. If the loss exceeds the shareholder's current taxable income, it may, in the same manner as any other loss, be carried backward or forward. Its only limit is the adjusted basis of the shareholder's stock plus the adjusted basis of any indebtedness the corporation may have to him. However,

174. § 1376.
176. § 1374(a); Hulsey v. Campbell, 64-1 U.S.T.C. ¶ 91,272 (1963); du Pont v. United States, 234 F. Supp. 681, 684 (D. Del. 1964) limits the applicability of Subchapter S losses to corporations that carry on a trade or business. It cannot be used to pass hobby losses on to the shareholders.

... a corporation is not eligible to make an election under sec. 1372(a) if it is in the process of complete or partial liquidation, or if it has adopted a plan of such liquidation ... in the near future.

However, this provision was never adopted.
178. § 1372(b); See Treas. Reg. § 1.704-1(d) examples 2 and 3 for illustrations.
179. §§ 1374(c) (2), 1376(b). This concept was introduced as § 704(d) of the partnership provisions during the 1954 re-write and seems to be limited to partnerships and Subchapter S corporations.
losses are treated somewhat differently from earnings. Both are personal\textsuperscript{180} and may not be transferred; but losses are incurred on a day-to-day basis\textsuperscript{181} while earnings are adjusted at the end of the year. A shareholder selling loss stock on the 30th of December only transfers one day's losses, while the sale of profit stock on the 30th passes all earnings for that year. This difference reflects the Treasury's attempt to prevent "high-bracket" taxpayers from capitalizing on the pass-through provisions of the Act. By taxing losses on a daily basis there is no advantage to purchasing the stock. If this were not so, the stock — with its built-in operating loss — could be sold to a "high-bracket" taxpayer in December, and he, in turn, could resell to a third party in January. Preventing the passage of accumulated earnings is no problem. The "high-bracket" man attempts to do everything possible to avoid taking earnings into his gross income. A purchase of stock in December could only add to his income, perhaps without even netting him a dividend.\textsuperscript{182}

If a loss occurs in a year following one when undistributed profits occurred, the loss must be deducted from previously taxed undistributed income.\textsuperscript{183} If the election is terminated, undistributed earnings will only be allowed to be taken out tax-free after all pre-election earnings have been distributed.\textsuperscript{184} In contrast, if the shareholders withdrew their profits when earned, they could not be locked in and losses generally could be utilized. The difficulty of getting previously taxed income out was likened by Moore and Sorlien\textsuperscript{185} to the problem Alice, of Alice in Wonderland fame, faced in obtaining looking-glass jam:

'You couldn't have it if you did want it,' the Queen said. 'The rule is, jam to-morrow and jam yesterday — but never jam to-day.'

'It must come sometimes to jam to-day,' Alice objected.

'No, it can't,' said the Queen. 'It's jam every other day: to-day isn't any other day, you know.'\textsuperscript{186}

II. TRANSMITTING THE CORPORATION TO THE CHILDREN

The shareholder who does not wish to sell or liquidate his corporation is faced with the problem of minimizing the eventual estate

\textsuperscript{180} Treas. Reg. § 1.1375-4(e) (1960).
\textsuperscript{181} § 1374(c).
\textsuperscript{182} See Moore & Sorlien, supra note 8, at 468.
\textsuperscript{183} § 1375(d) (2) (B).
\textsuperscript{184} Treas. Reg. §§ 1.1375-4(a)-(b) (1960).
\textsuperscript{185} Supra note 8, n.33, at 468.
\textsuperscript{186} CARROLL, ALICE'S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING-GLASS 225 (World Pub. Co. 1946 ed.).
tax imposed on his shares. Several alternatives are available. To a limited degree they may also be used by a Subchapter S corporation.

A. The Redemption

The corporate shareholder may anticipate heavy estate taxes and either accumulate funds during his lifetime or purchase life insurance to meet this burden. As an alternative the corporation itself may accumulate a reserve large enough to pay estate taxes owing by its principal owners. This, in fact, may be the only solution if the shareholders are saddled with a provision completely or partially restraining the transferability of their stock. Assuming the company has been incorporated in a jurisdiction which permits corporations to purchase their own shares, certain restrictive conditions must still be met. The local corporation law will probably require that purchases be made from earned surplus. If the security behind outstanding debentures is impaired, if contract rights of preferred shareholders are impinged, or if the firm itself is drained of operating capital, the purchase becomes infeasible, if not illegal. However, the corporation may have taken out an insurance policy on the life of the decedent and now have sufficient funds to acquire his shares. If the firm has available funds and certain conditions are met, a portion of the shares formerly held by the decedent may be redeemed by

187. The executor must include the fair market value of the decedent's shares on the date of his death in the estate. No credit or deduction is given for constructive dividends retained in the business, although they have increased the basis of the stock which will prove of value if the stock is liquidated § 1376(a). See Peden, Problems Resulting from the Death of the Principal Partner or Principal Shareholder, N.Y.U. 21ST INST. ON FED. TAX 1051, 1061-62 (1962).

188. This presupposes that these funds are such that they are not deemed to be an excessive accumulation of earnings under § 532(a). This section imposes a tax upon "every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." It would seem that this provision requires a showing by the Commissioner that the company not only accumulated funds far beyond what were needed to operate the business but did so as a tax avoidance device. Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960) (the tax should only be imposed when the dominant or primary purpose of accumulating funds was the avoidance of tax on the company's shareholders); Henry Van Hummell, Inc., 23 CCH Tax Ct. Mem. 1765 (1964); see Herwitz, Stock Redemptions and the Accumulated Earnings Tax, 74 Harv. L. Rev. 866, 874-78 (1961).

189. O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 Harv. L. Rev. 773, 776-77 (1952), believes such provisions are commonly encountered in the charters of small closely held corporations. By way of illustration he lists seven distinct types of restrictions commonly imposed on the transferability of common stock.

190. Id. at 795.

191. For a good discussion of this problem see Ballantine, Corporations §§ 256-72 (rev. ed. 1946).

the corporation. The proceeds, if taxed at all, will be subject to capital gain rather than ordinary income rates.\textsuperscript{193}

To have a partial redemption of a former shareholder's interest under § 303, a series of fairly restrictive conditions must be met. The securities about to be redeemed must be included in the gross estate\textsuperscript{194} and may not exceed the amount of "the estate, inheritance, legacy, and succession taxes . . . imposed because of such decedent's death,"\textsuperscript{195} and the . . . funeral and administration expenses. . . ."\textsuperscript{196} A further requirement is imposed on the stock: it must comprise 35 percent or more of the value of the decedent's estate.\textsuperscript{197} To successfully apply this provision, the redeeming company must have available liquid funds,\textsuperscript{198} or be in a position to borrow redemption cash; the estate must hold the firm's stock as its principal asset and owe sizeable death taxes.

When the heirs are the corporation's sole shareholders, or the remaining owners are agreeable, the corporation may completely redeem all, or a substantial part, of the decedent's stock — again at capital gains rates. Section 302 will permit such a redemption if: (a) the stock remaining in the hands of the redeemers (heirs) represents less than 50 percent of the outstanding voting power,\textsuperscript{199} and (b) the redemption qualifies under the ratio of the voting stock owned by the redeemers after the redemption by being less than 80 percent of the ratio of the redeemer's stock to all the voting stock before the redemption.\textsuperscript{200} Termination of the redeeming party's entire interest also qualifies the redemption.\textsuperscript{201} As a practical matter, when three of the four equal heirs wish to terminate their interest, they may do so without any difficulty.\textsuperscript{202} It is only when they all wish to reduce

\textsuperscript{193} § 303(a) "A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation . . . shall be treated as a distribution in full payment in exchange for the stock so redeemed."

\textsuperscript{194} Ibid.

\textsuperscript{195} § 303(a) (1). This is not to say that the funds actually must be used for these purposes. The enumerated purposes only serve to limit the amount that may be taken out of the corporation under this provision.

\textsuperscript{196} § 303(a) (2).

\textsuperscript{197} § 303(b) (2) (A) (i). Actually the Code provides for two alternative situations to the 35 percent rule. If 50 percent of the taxable estate is composed of a single corporation's stock or if 75 percent of the estate is tied up in the stock of two or more corporations this stock may be redeemed, § 303(b) (2) (B). See Bittker, op. cit. supra note 68, at 236-38, where he points out, that Treas. Reg. § 1.303-2(d) (1955), allows even "§ 306 stock" to be redeemed.

\textsuperscript{198} § 6166(a) eases this burden by permitting an estate meeting the requirements of § 303(b) (2) (B) to pay the federal estate tax in not more than 10 equal installments spread over a 10 year period.

\textsuperscript{199} § 302(b) (2) (B).

\textsuperscript{200} § 302(b) (2) (C).

\textsuperscript{201} § 302(b) (3).

\textsuperscript{202} As § 302(c) incorporates § 318(a) [78 Stat. 762 (1964)] care must be taken to be certain that the stock held by the remaining heirs, (through constructive ownership) is not sufficient to destroy the redemption.
their holdings that complications arise. When the heirs, or the estate wish to take as much cash as possible out of the corporation without completely stepping out, § 303 should be applied before a § 302 redemption is attempted. As § 303 is the more restrictive section, it may be used without hampering a § 302 redemption. However if the parties first proceed under § 302 they will lose the benefit of § 303.208 Factors other than tax considerations often block a redemption in the last analysis. A redemption would permanently stunt the enterprise’s growth if it is young, growing, and constantly in need of funds. Such a procedure would be out of the question if the remaining shareholders are not amiable to a redemption of the decedent’s interest.204

Subchapter S stock that has not been willed to a trust205 and meets a few additional qualifications can be redeemed. The firm may still operate in the Subchapter S form after redemption. The election will not be destroyed if a portion of the outstanding shares is held as treasury stock,206 nor will it terminate if an estate is one of its shareholders.207 However the executor must be careful to file a written “consent” within 30 days after he has qualified under local law,208 or the corporation will automatically lose its elected status.209 Distribution of stock to more than ten heirs also terminates the election.

The corporation has three sources of funds, which it may use to redeem a decedent shareholder’s stock: it may use retained pre-election earnings and profits; or post-election retained earnings; or it may elect to sell a portion of its operating assets. In each instance the distribution will not be taxed as ordinary income. The effect on the corporation’s earnings and profits or the adjusted basis of the remaining shares may vary depending upon the source of the funds. Bittker indicates that the entire question is cloaked with considerable doubt.210 Section 312(e) provides that the part of the “distribution which is properly chargeable to capital account shall not be treated as a distribution of earnings and profits.” After a charge is made

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203. See Gelband, Tax Trap Hidden in Sec. 303; Careful Timing of Other Redemptions Necessary, 8 J. TAXATION 244 (1958).
204. Peden, supra note 187, at 1060, suggests three ways to mitigate these problems: (1) an agreement among the shareholders to bind their successors to consent to the election; (2) an agreement forbidding transfer to non-consenting shareholders; (3) a statement of the problem in the by-laws. Nine methods are listed by Moore & Sorlien, supra note 8, at 485–86.
205. Treas. Reg. § 1.1371–1(g) (1960); 1 Old Virginia Co., 44 T.C. No. 69 (1965).
208. While Treas. Reg. § 1.1372–3(a) (1964) allows the district director to grant an extension if certain conditions are met the taxpayer has no right to one; thus he may find it difficult to convince the district director that an extension is warranted.
209. § 1372–(e)(3). The heir must also be careful to file a “consent” to the Subchapter S election within 30 days after receipt of the stock. Treas. Reg. § 1.1372–3(b) (1960).
to capital, the balance should go to reduce pre-election earnings. This reduction should allow a portion of future distributions to be taxed as dividends rather than as a return of capital. A different result may be expected if the corporation has retained a portion of its post-election, but none of its pre-election, earnings. Section 1.1373-1(e) of the regulations states that earnings should first be allocated to dividends, then to property other than money, and finally "the remainder . . . is available to be allocated to distributions in exchange for stock of the corporation such as distributions under section 302 or 331." But even if this provision reduces the earnings and profits account, the remaining shareholders do not stand to benefit from the reduction. The retained post-election earnings are "personal and cannot in any manner be transferred to another." Earnings in excess of distributions will only increase shareholders' basis rather than supplementing the pre-election earnings and profits account. Conversely, redemptions or partial liquidations occurring after a Subchapter S corporation has been terminated will not be improved by prior redemptions. A sale of property by the corporation with the proceeds used to redeem a portion of the outstanding stock will be taxed as capital gain to each shareholder to the extent the sale price exceeds the basis of the asset and is not in excess of the corporation's taxable income. The remaining shares will suffer neither gain nor loss due to this transaction. Once it is anticipated that substantial sums have to be taken out of the business to pay estate taxes the corporation is well advised to pay out all post-election earnings as dividends. The redemption would then come out of pre-election earnings and profits or new debt incurred for this purpose.

B. Reducing the Tax Liability

The alternative to acquiring sufficient funds to pay the decedent's estate tax is reduction of the taxable estate. The methodology for accomplishing this project is effectively limited by the present tax structure to inter vivos gifts.

Few men object to reducing a tax liability; however, few desire to give up control of their property merely to reduce the tax burden.

211. § 312(a); Bittker, op. cit. supra, note 66, at 245.
212. § 316(a); Treas. Reg. § 1.316-1(a)(2) (1955).
216. § 1376(a).
219. § 1375(a). As with earnings the tax applies even if the proceeds are not distributed. Capital gains are discussed in more detail at pp. 37-38 infra.
their heirs will be required to face. Family relationships must also be considered. If a gift of property to children will make them independent of their parents, any successful program will need as one of its features some means of delaying enjoyment until the donees have attained sufficient maturity to competently deal with their bequests. When dealing with a donor whose principal asset is securities in a closely held corporation, a special problem often must be overcome. The program must be constructed so the donor will not lose control of his firm. This is especially so if he is employed by the firm and takes as salary a substantial portion of his return. Thus, any program to meet with widespread acceptance will have three features: it will remove property from the holder's estate; it will not substantially impair the current income of either the donor or the company; and it will not jeopardize the holder's position in his firm. Generally, there are several possible solutions; however Subchapter S shareholders seem to be limited to one.

The simplest alternative is the outright inter vivos gift of stock from father to son. 220 So long as the donee receives an immediate ownership interest, or, in the language of the Code, "receives a present interest," 221 the transaction qualifies for the gift tax exemption. Only when the gift has strings attached or is a gift of a "future interest," will it fail to receive the exemption. 222 Any donor, who persuades his wife to file a notice of consent, may make an initial tax-free gift 223 of $60,000 224 and may add $6,000 per year per child. 225 In practice once a continuous annual giving plan is initiated, it can be continued indefinitely without fear of being declared a gift in contemplation of death and thereby included in the donor's estate for tax purposes. 226 Depending upon the number of recipients, $200,000 to $300,000 can be lopped off the donor's estate in a ten or fifteen year period. The Subchapter S shareholders may use a giving program in the same manner as the normal corporate shareholder uses his. There is one difference. That portion of the earnings attributable to the children's

220. As each child will count toward the 10 shareholder limit a widespread giving program may be impractical. Treas. Reg. § 1.1371-1(d)(1) (1960).
221. § 2503(b).
222. § 2503(c).
223. This only is an exemption from the federal gift tax; several states have local provisions which would impose some tax liability upon the donor. For a list of state gift tax statutes see Logan, supra note 192, at 604.
224. § 2521.
225. §§ 2503(b), 2513(a)(2).
226. § 2035 includes all gifts made in contemplation of death. Estate of Johnson, 10 T.C. 680, 687-92 (1948), contains an excellent discussion of the various factors that must be considered in determining whether a gift was made in contemplation of death. A series of gifts made over a prolonged period is almost conclusive proof that none of the gifts were in contemplation of death.
shares will be taxed to them\textsuperscript{227} even though retained in the business.\textsuperscript{228} If the principal shareholder-donor has a marginal tax-rate of 60 or 70 percent, this provision will serve him well, especially if his children are expected to come into the firm. Conceivably they can come in with high basis stock and the built-in privilege of withdrawing substantial sums — accumulated at low rates — tax-free.

Although the Commissioner has ruled a gift of stock to a child acceptable for income and estate tax purposes,\textsuperscript{229} this type of gift may encounter other difficulties. A few states still do not permit minors to hold securities, most brokerage houses refuse to transfer stock held in a minor’s name, and income paid to the minor that is expended for his support may end up on the donor’s income tax return.\textsuperscript{230} Generally these problems can be overcome if some form of a trust, custodian, or statutory guardian holds the securities.\textsuperscript{231} Unfortunately the use of a trust is unavailable to a Subchapter S shareholder. Section 1371(a)(2) of the Code and § 1.1371-1(g) of the regulations specifically prohibits trusts — even voting trusts\textsuperscript{232} — from holding Subchapter S stock. While it may be debated whether this provision was warranted,\textsuperscript{233} there is no question that it has destroyed one of the estate planner’s basic tools. However a custodianship may be used. The Commissioner

\textsuperscript{227} § 1373(b).
\textsuperscript{228} § 1373(b). See also Anthoine, \textit{supra} note 12, at 1167.
\textsuperscript{230} Visintainer v. Commissioner, 187 F.2d 521 (10th Cir.), cert. denied, 342 U.S. 858 (1951); Pfugradt v. United States, 201 F. Supp. 379, 383-84 (E.D. Wis.), \textit{aff’d}, 310 F.2d 412 (7th Cir. 1962); Lawrence Miller, 2 T.C. 285, 288 (1943); Edward H. Heller, 41 B.T.A. 1020, 1031 (1941), \textit{aff’d without discussion of this point, sub nom. Ehrman v. Commissioner}, 120 F.2d 609 (9th Cir.), cert. denied, 314 U.S. 668 (1941).
\textsuperscript{233} In support see Note, \textit{Optional Taxation of Closely Held Corporations under the Technical Amendments Act of 1958}, 72 \textit{HARV. L. REV.} 710, 711-12 (1959): The denial of subchapter S treatment to corporations any of whose stock is owned by a trust may be attributable to two factors. First, it may have been intended to prevent circumvention of the rules for eligibility, such as the ten shareholder rule. Second, considerable difficulty would have been created in the administration of trusts and in their taxation. However, the Tax Court recently indicated, by way of dicta, that this portion of the regulations, if put to a direct test, may be invalid. In Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1368 (1964), after first pointing out that for purposes of the instant decision it is not necessary to determine whether a voting class creates a second class of stock, the following statement is found: “However we do deem it appropriate to note our reservations as to whether these arguments [made by the Commissioner] represent a reasonable interpretation of the applicable statutory provisions.” \textit{Cf. Commissioner v. Nat’l Bellas Hess, Inc.}, 220 F.2d 415, 420, \textit{aff’d without mention of this argument on rehearing}, 225 F.2d 340 (8th Cir. 1955).
has indicated gifts of stock to minors held by a custodian will be considered gifts of a "present interest," therefore qualifying for the annual $3,000 gift tax exclusion. This provision also applies to Subchapter S corporations; thus, a donor may give Subchapter S stock without terminating the election. When compared to a trust, a custodianship is a pale second choice. It appears to have all of the disadvantages without any of the benefits. Section 677(b) is illustrative of the benefit given to a trust settlor that is not accorded to a guardianship settlor. The pertinent portion of this provision provides:

Income of a trust shall not be considered taxable to the grantor . . . merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied.

If this section is limited to trusts then Helvering v. Stuart, the moving force behind the enactment of § 677(b), would be resurrected; the donor would be taxed on any income that could be spent for support of the beneficiaries. Almost any expenditure a legal guardian would be inclined to make, with the possible exception of furnishing the funds for a college education, could be deemed to relieve the donor of his support obligation. The regulations add to the difficulty by making it clear that interfamily transfers of Subchapter S stock will be closely examined. Distributions may be reapportioned within the family group if they are found to be disproportionate or not reflective of the value of services the owners have rendered the

237. Several cases have held that parents have an obligation to provide their children with a college education. While it is true that these decisions arose in divorce proceedings the handwriting is on the wall. Strom v. Strom, 13 Ill. App. 2d 354, 142 N.E.2d 172 (1957); Rawley v. Rawley, 94 Cal. App. 2d 562, 210 P.2d 891 (1949); Cohen v. Cohen, 193 Misc. 106, 82 N.Y.S.2d 513 (Sup. Ct. 1948); Jackman v. Short, 165 Ore. 626, 109 P.2d 860 (1941); Feek v. Feek, 187 Wash. 573, 60 P.2d 686 (1936); Refer v. Refer, 102 Mont. 121, 56 P.2d 750 (1936); Payette v. Payette, 85 N.H. 297, 157 Atl. 531 (1931); contra, Morris v. Morris, 92 Ind. App. 65, 171 N.E. 386 (1930); Streitwolf v. Streitwolf, 58 N.J. Eq. 570, 43 Atl. 904 (1899); Annot., 56 A.L.R.2d 1207, 1220-33 (1957); See generally Miller, Appropriate Forms of Gifts to Minors, N.Y.U. 16th Inst. On Fed. Tax 765, 770 (1958).
238. Treas. Reg. § 1.1373-1(a) (2) (1960); see also Cowen, supra note 156, at 90.
corporation. While the Commissioner is busy examining the nature of the distributions it is not unreasonable to expect that he might also examine the guardian's disposal of the minor's income. But, even with all its shortcomings, the custodianship or guardianship must be used with minor stockholder-donees — nothing else is available. The practical effect of this limitation will force the donor to insure that all dividends are constructive (retained by the corporation) or are accumulated by the guardian until the minor reaches his twenty-first birthday when they must be distributed to him.\(^{241}\)

Once the hurdles of drafting a successful guardianship are overcome, several problems still remain. Control of the corporation is one;\(^{242}\) in some cases it may be the deciding factor whether a guardianship is to be created at all. If the donor is the sole owner, this problem generally will not arise. But what happens if he owns 40 percent of the stock and three adverse parties own the remaining 60 percent? In this situation the guardian will be required to vote any stock given him along with the donor. The obvious solution — the parent-donor acting as guardian — destroys the validity of the gift. Then, in all probability, these shares not only will be included in the donor's estate, but the current income will, under the *Lucas v. Earl*\(^{243}\) doctrine, be taxed to him as well.

The criteria for guardianships are not well developed, but, at least in this area, the standards worked out for trusts should be applicable. To pass both the corpus and the income, care must be taken in drawing up the guardianship agreement that:

1. The donor does not have the power to replace the adverse trustees (guardians) except in accordance with definite prescribed standards;\(^{244}\)

\(^{241}\) Treas. Reg. § 25.2503-4(c) (1958); this regulation attempts to modify Commissioner v. Disston, 325 U.S. 442 (1945) and Fondren v. Commissioner, 324 U.S. 18 (1945), holding that corpus pay-outs occurring after the minor's twenty-first birthday were, under the 1939 Code, gifts of future interests. In *Rev. Rul. 60-218*, 1960-1 Cum. Bull. 378, it was ruled that a trust allowing the beneficiary to compel distribution when he reached twenty-one did not qualify. He must not be required to perform an overt positive act of either requiring the corpus to be distributed or requiring it to be accumulated; the trustee must be required to distribute the corpus unless the beneficiary specifically orders him to do otherwise. See Frazier, *Recent Developments in Trusts for Minors*, N.Y.U. 21st Inst. on Fed. Tax 299, 300-01 (1963). In Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962), affirming, 35 T.C. 732 (1961), the grantor provided that all income would be paid out when the beneficiary reached twenty-one; he would receive the corpus at thirty. The Tax Court held that a trust may be split into two parts — income and corpus; only the corpus was deemed to be a future interest. Thus, the grantor may claim a gift of the present value of the income right. The Commissioner has not acquiesced in this decision. 1962-2 Cum. Bull. 6; cf. Walter v. United States, 295 F.2d 720 (6th Cir. 1961).

\(^{242}\) Roberts & Alpert, supra note 234, at 4.

\(^{243}\) 281 U.S. 111 (1930).

\(^{244}\) A donor having unlimited power to remove trustees without cause and replace them was in Loughridge's Estate v. Commissioner, 183 F.2d 294 (10th Cir.), cert.
Neither the income nor the corpus can revert back to the donor within ten years;\(^2\)\(^4\)\(^5\)

(3) The donor does not have a power of disposition without consent of an adverse party;\(^2\)\(^4\)\(^6\)

(4) No administrative controls are retained by the donor;\(^2\)\(^1\)\(^6\)

(5) The trust (guardianship) is not revokable;\(^2\)\(^4\)

(6) The donor does not have the power without the consent of an adverse party to distribute income to himself and denied, 340 U.S. 830 (1950), considered subject to both income and estate taxation under Helvering v. Clifford, 309 U.S. 331 (1940). In the words of Caplin, supra note 229, at 372:

Under the 1939 Code . . . through this incident of dominion and control, the donor was deemed to possess all of the powers initially granted to the trustee; and, where the actual possession of such powers by the donor would have resulted in his being taxable, this constructive possession similarly brought taxation. See Warren H. Corning, 24 T.C. 907 (1955), aff'd, 239 F.2d 646 (5th Cir. 1956); Louis Stockstrom, 4 T.C. 5 (1944), aff'd, 151 F.2d 353 (8th Cir. 1945); cf. Hormel v. Helvering, 312 U.S. 552 (1941). The result will probably be the same under the 1954 statute. Walter v. United States, 295 F.2d 721 (6th Cir. 1961), citing with approval Lober v. United States, 346 U.S. 335 (1953) and Du Charme's Estate v. Commissioner, 164 F.2d 959 (1947), modified, 169 F.2d 76 (6th Cir. 1948). However, when the 1954 Code was enacted all of § 851 of the A.L.I. INT. INCOME TAX STAT. (February, 1954 draft), was adopted except § (d) which read: "If the grantor or a related or subordinated party has the power to remove a trustee without cause, the grantor shall be treated as possessing the powers of that trustee." This provision was not included in either the House or Senate Bills when they came out of committee. S. Rep. No. 1662, 83d Cong., 2d Sess. (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954). It is interesting to note that the Advisory Group on Subchapter J of the Internal Revenue Code of 1954, Revised Report on Trusts 42 (1957) recommended that § 672 be left unchanged.

A substitution required by the incapacity of a trustee should not make the trust taxable to the donor. Rev. Rul. 55-393, 1955-1 Cum. Bull. 448; United States v. Winchell, 289 F.2d 212, 216-17 (9th Cir. 1961); Jennings v. Smith, 161 F.2d 74, 77 (2d Cir. 1947); Kohnstamm v. Pedrick, 153 F.2d 506, 509 (2d Cir. 1945); Cent. Nat'l Bank v. Commissioner, 141 F.2d 352, 355 (6th Cir. 1944); Estate of Newcomb Carlton, 34 T.C. 988, 996 (1960), rev'd on other grounds, 298 F.2d 415 (2d Cir. 1962); see generally Casner, op. cit. supra note 192, at 202-03.

245. § 673(a) and (d). In addition Treas. Reg. § 1.677(a)-1(g) (example 2) (1956) points out any capital gain realized by the trust will be taxed to the donor if he retains a reversionary right. For this reason revocable trusts have been disregarded as an alternative method of dealing with the problem at hand. Cf. Miller, supra note 237, at 772.

246. § 674(a). The power to shift property from one beneficiary to another, even if not exercised, will be sufficient to include the trust corpus in the donor's estate. §§ 2036(a) (2), 2038(a) (1); Treas. Reg. § 20.2038-1(a) (1958); Commissioner v. Estate of Holmes, 326 U.S. 480, 487 (1946); Porter v. Commissioner, 288 U.S. 436 (1933); Commissioner v. Hohlsheimer's Estate, 149 F.2d 733, 735-36 (2d Cir. 1945); Pedrick, supra note 236, at 534.

247. § 675(a); James L. Darling, 43 T.C. No. 43 (1965); cf. Thompson v. United States, 209 F. Supp. 530, 539-41 (E.D. Tex. 1962) (grantor may retain power to select individual beneficiaries).

248. § 676(a).

249. § 677(a) (1) and (2); Lober v. United States, 346 U.S. 335 (1953). In 1959 the First Circuit in State Street Trust Co. v. United States, 263 F.2d 635, confused the area further by ruling that a grantor retaining trustee powers, even in connection with a corporate fiduciary, has retained sufficient ownership to have the property included in his estate. This decision was followed by the Tax Court. Estate of John J. Rose, 37 T.C. 970, 978-81 (1963), aff'd, 332 F.2d 590 (1st Cir. 1964); cf. Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955); Rundle v. Welch, 184 F. Supp. 777 (S.D. Ohio 1960); but was rejected by United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Willard V. King, 37 T.C. 973, 978-81 (1962) (grantor who, in
(7) The agreement is drawn in accordance with local trust and tax statutes. The donor may overcome all of these difficulties by naming a corporate fiduciary as sole trustee (guardian). However the donor may require that he retain some power — if only a power of suggestion — over the voting of this stock. It would seem that a joint donor-corporate-fiduciary guardianship, with the latter having final control, would be the answer. Again drawing from the trust regulations, the standard, described in terms of power, would seem to be complied with:

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries.

Without getting into the factual question of what is “primarily in the interest of the beneficiaries” it would seem that Congress only intended the donor to act in other than an unbridled fashion. The donor’s serving as joint guardian along with a bank would satisfy the statute; the minor beneficiary would be protected; and the grantor would be secure, for he would probably influence the bank to vote in a manner to preserve his position in the company. Unfortunately, the First Circuit, in a recent decision, seems to have disregarded the spirit, if not the letter, of this section. In *State Street Trust v. United States* the court held that a grantor, who as co-trustee with a corporate fi-
duciary retained the power to participate in the decision whether income would be accumulated or paid out, had retained sufficient incidents of ownership as defined by §§ 2036 and 2038 to require that the corpus of the trust be included in his taxable estate. It is only a short step to a similar holding when the donor retains voting powers — § 675(4) notwithstanding. Whether State Street Trust was or was not correctly decided remains an open question; in any case the handwriting is on the wall. Joint guardianships are dangerous. If at all possible they should be avoided. In the normal corporate situation this problem may be eliminated by tying the donee's voting power to a voting trust; however this alternative is not available to the holder of Subchapter S stock. Nevertheless, one final possibility remains. Section 1.1371-1(g) of the regulations provides in part:

A corporation having more than one class of stock does not qualify as a small business corporation. . . . However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock.

If this provision means that shareholders may be limited to voting for a director to represent their particular group, a little judicious gerrymandering will protect the majority position. Merely by giving the stock from one or two groups the donees may be limited to one or two board seats, or if stock is only given from those groups where the donor has a strong position, the donees can be denied any representation. Before relying on such a nebulous provision, the practitioner would be well-advised to seek a favorable revenue ruling.

In the great "give-away" program, the Subchapter S shareholder is severely hampered when compared with the normal corporate owner. His flexibility is sorely limited. None of the three most widely used techniques for passing a corporation on to the second or third generations are available to him. Normally the principal owners may issue

254. LATIN, CORPORATIONS 325, n.32 (1959), lists thirty-five states and the District of Columbia as specifically authorizing by statute the use of voting trusts. He points out, at 325, that the majority of the statutes provide for irrevocable voting trusts for a period of not over 10 years, many of them with renewal provisions . . . for another ten years . . . . "The leading case in this area is Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947). In support of the majority position BALLANTINE, CORPORATIONS § 184, at 426 (rev. ed. 1946) states:

The current prevailing view toward voting trusts has come to be that they are valid even in the absence of statute, except where an improper motive or object is shown. The reason is that this device is the only sure method of binding shareholders to vote as a unit and thus assuring a desirable stability and continuity in management in situations where that is needed.

See also BAKER AND CARY, CORPORATIONS 262-66 (3d ed. 1959); 5 FLETCHER, CVC. CORP. § 2064 (Perm. ed. 1952).

themselves preferred stock and give the common to their children. The receipt of the preferred is tax-free and the common passes under the high exemption gift tax provisions. The donor typically continues to operate the business (taking his return as salary) until he is ready to retire. At this point the corporation redeems all preferred. As the redemption terminates his interest in the corporation, any gain to the donor is only taxed at capital gain rates; any increase in the value of the company during this period is attributable to the common and is not taxed at this juncture. The same objective (with control retained by the donor) may be accomplished by reincorporating the company into voting and non-voting stock and giving away the non-voting shares. This can be done in either of two ways. The shareholders can turn in their old common stock for class A and class B stock, with A alone having voting rights, or non-voting stock can be distributed as a dividend. The shareholders receiving these dividends, will, in turn, pass them on to the donees. Although the concepts are simple, the mechanics of these transactions pose tremendous difficulties. In any event these alternatives are foreclosed to Subchapter S shareholders. Section 1371(a)(4), it will be remembered, limits an electing corporation to one class of stock. The regulations issued to clarify this section do not merely prevent the corporation from issuing preferred; they provide that “a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation.” Therefore, the Subchapter S stockholder is effectively limited to disposing of his stock through an outright gift.

C. Valuing the Stock

Some methods of valuing the stock must be developed. The Commissioner, for obvious reasons, requires a determination to be made. The donor will need to know how much stock may be passed

256. § 305.
257. § 306(b) (1) (A) (iii).
258. For a detailed discussion of the mechanics of these transactions see Hrusoff, Minimizing the Estate Tax Bite, 39 Tul. L. Rev. 263, 272-78 (1965).
to the beneficiaries before a gift tax will be imposed. The problem exists whether the donor transfers ordinary or Subchapter S stock. It seems that the valuation of a subchapter S corporation should be little, if any, different from any other closely held corporation. However, one difference exists. The value of Subchapter S stock will be depressed if the corporation has distributed earnings to the decedent during the year and then the executor fails to make a timely election. The corporation then will have to pay taxes on its entire income for the year, reducing the value of the stock by the amount of the tax. 261

If the donor's principal aim is the reduction of his estate and if control is a problem, a Subchapter S corporation will hamper him. But if he desires to spread income among his children while reducing his estate, a Subchapter S corporation will serve him well. This is especially so if he is the sole owner and if control is no problem. No other program allows substantial gifts which reduce both current income and the eventual estate tax. On balance, the possibility that a corporation's owners may wish to give stock to their children should not stand in the way of an election; if anything, it may promote it.

III.

SALES AND LIQUIDATIONS

The final section is concerned with the so-called "termination transactions." It attempts to describe the effect on the corporation and the shareholders in each of three common situations. For this reason it is divided into three parts. Part A deals with the shareholder who sells his Subchapter S stock to another individual; B is concerned with a sale of a portion of the corporation's assets; C treats liquidations, including bankruptcies. Although sales and liquidations under Subchapter S are, in the majority of cases, taxed in the same manner as similar corporate transactions, there are several important differences. These differences warrant discussion.

A. Sales and Transfers

The corporation itself is not affected by the sale or transfer of its stock so long as the new owner agrees that the election shall continue. Refusal, of course, terminates the election. At the shareholder level both purchaser and seller should treat this sale as they would any other transfer; it would be different if retained earnings could be transferred, but, as they cannot, there is no reason to handle

261. See Peden, supra note 187, at 1061.
this sale differently from any other. Earnings that have not been withdrawn when the stock is sold are lost. As the buyer realizes he cannot obtain these retained earnings except as dividends he would be foolish to pay a premium for them. The selling shareholder is paying regular income for capital gain if he fails to withdraw earnings that he has had taxed to him at regular income rates. Therefore, if at all possible, retained earnings should be withdrawn prior to sale.

B. Capital Gains

Section 1375 allows long-term gain from the sale of property not held primarily for sale in the ordinary course of trade\textsuperscript{262} (not in excess of earnings and profits) to be passed through to the shareholders.\textsuperscript{263} This gain is included in their income in the same manner as if they, not the corporation, held title to the property which was sold. Capital gains are not set-off against operating or capital losses; in fact, capital losses do not pass through to Subchapter S shareholders.\textsuperscript{264} On balance shareholders are given a break. They are allowed to take capital gains into their income at the 25 percent maximum rates while applying losses against ordinary income taxed at 50, 60 or 70 percent. Due to the requirement that gain must be distributed in the year it is received, a certain amount of difficulty was always encountered. If a corporation selling property early in the year distributed the proceeds at this time, and then later in the year experienced losses, the capital gain would be converted to ordinary income. The corporation that waited until its books were closed had difficulty distributing the proceeds before the year ended. Congress added paragraph (e) to section 1375 last year\textsuperscript{265} to avoid this dilemma. Section (e)(1) allows a distribution made within 75 days after the close of the corporation's taxable year to be treated as if it were made before the year ended. All that is required is that the distribution must be pursuant to a board resolution; the resolution, which must be made in the year of sale, need only order that some of the anticipated capital gain be distributed. Section (e)(2) deals with the shareholders. It requires all shareholders at the close of the year to maintain their position until the distribution occurs. Section 1375 allows the owners of a corporation to utilize an election when they anticipate a sale resulting in substantial gain. They substitute a capital

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{262} § 1375(a)(1); § 1221 and Treas. Reg. § 1.1221-1(1)(b) (1957), further define this provision.
\item \textsuperscript{263} Ibid.
\item \textsuperscript{264} Ibid. This does not mean that shareholders are prohibited from sustaining capital loss upon the sale or exchange of Subchapter S stock to the extent provided by § 1211(b). Anthony Granota, 22 CCH Tax Ct. Mem. 1633 (1963).
\end{enumerate}
\end{footnotesize}
gains tax for a capital gains tax followed by an ordinary dividend by electing. The saving can be substantial. However, as seems to be the case with every other section, there is an exception. No gain may be passed through if the shareholders are using an election to avoid having their operation taxed as a collapsible corporation. In this area Subchapter S is consistent with the collapsible corporation and collapsible partnership provisions. Thus, gain from a sale that fails to meet the tests imposed by § 341 will be treated as ordinary income.

C. Liquidations

One of the principal advantages of Subchapter S is its liberal liquidation provisions. If correctly used, substantial sums can be saved. At the outset it is now well settled that a corporation may elect even though it is in the process of liquidation. Once an election is made the corporation that sells its assets and distributes the proceeds will incur only one tax — a capital gains tax at the shareholder level. The non-electing corporation will be taxed on the sale and the shareholders will be taxed again when the proceeds are distributed. Thus, a timely election eliminates one tax. Moreover, a corporation liquidating after election, in contrast to one bowing out under § 337, is not penalized if it sells its property on an installment basis. This fact alone may sometimes make a Subchapter S liquidation superior to a § 333 or § 337 liquidation.

The election may become even more profitable, in the proper circumstances. Thus, if the corporation is operating in the red, all operating losses sustained during liquidation may be passed on to the shareholders; in contrast, a similar corporation dissolved under § 337 must set off operating losses against capital gains. By coupling a Subchapter S election with a § 337 liquidation, the operating losses can be passed on to the shareholders, who will in turn deduct them from ordinary income. It is not surprising that the temporary regulations prevented an election when in the process of liquidation. Had

266. § 751.
267. Treas. Reg. §§ 1.1375-1(c)(8), 1.1375-1(d) (1960); see also 7 MERTENS, LAW OF FEDERAL INCOME TAXATION § 41B.35 (1962); Alexrad, Recent Developments in Collapsible Corporations, 36 TAXES 893, 906 (1958); Note, Tax-Free Sales in Liquidation under Section 337, 76 HARY. L. REV. 780, 798-800 (1963).
269. An exception is made if the corporation qualifies under § 333.
270. § 337(b) (B)-(C); cf. Family Record Plan, Inc., 36 T.C. 305 (1961), aff'd on other grounds, 309 F.2d 208 (9th Cir. 1962), cert. denied, 373 U.S. 910 (1963).
271. The installment sale presents no problem for the tax is only imposed on the proceeds as they are received. § 1375(a) (2).
they allowed the stockholders to elect without meeting a multitude of restrictions but denied the right to terminate until two years after election, they would have better served the Treasury's purpose. It may now be too late to correct this defect without a change in the statute.273

For the corporation to sell its assets tax-free under § 337, it must formally adopt a plan of liquidation,274 and subsequently carry out the plan within a 12 month period;275 a sale followed by a plan will not do.276 Caution is called for in treating this area, for recently the Service has attempted to restrict the deductions allowed under § 337277 with some success. It seems established that the taxpayer will be allowed legal expenses incurred in a complete liquidation,278 and may deduct state liquidating taxes assessed against the company;279 but the majority of cases have held bad debt reserves taxable as income.280 Additionally, the Commissioner has ruled that previously deducted maintenance — such as coal to heat a building, or small hand tools with which to maintain it — must be included as income.281 This ruling has not as yet been tested.

Perhaps the most interesting of all these § 337 conflicts is now being waged over the Commissioner's contention that a sale before the end of an asset's depreciable life, for a sum in excess of remaining depreciation plus salvage, works a disallowance of depreciation taken during the year of sale. The absence of a logical foundation to this

274. § 337(a) (1); see generally Rice, Problems in Section 337 Liquidations, N.Y.U. 20th Inst. on Fed. Tax 939 (1962); Note, Tax-Free Sales in Liquidations under Section 337, 76 Harv. L. Rev. 780, 782-90 (1963).
275. § 337(a) (2).
276. Wendell v. Commissioner, 326 F.2d 600 (2d Cir. 1964); United States v. Diversified Servs., Inc., 312 F.2d 393 (5th Cir. 1963); Wood Harmon Corp. v. United States, 311 F.2d 918 (2d Cir. 1963); J. C. Penney Co. v. Commissioner, 312 F.2d 65 (2d Cir. 1962); The Covered Wagon, Inc., 24 CCH Tax Ct. Mem. 427, 641 (1965).
280. Arcadia Sav. & Loan Ass'n v. Commissioner, 300 F.2d 247 (9th Cir. 1962); West Seattle Nat'l Bank v. United States, 288 F.2d 47 (9th Cir. 1961); Citizens Fed. Sav. & Loan Ass'n v. United States, 154 Ct. Cl. 305, 290 F.2d 932 (1961); Estate of Heinz Schmidt, 42 T.C. 1131 (1964); contra, James M. Pierce Corp. v. Commissioner, 326 F.2d 68 (8th Cir. 1964); cf. Calavo, Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962); Home Sav. & Loan Ass'n v. United States, 223 F. Supp. 134 (S.D. Cal. 1963). See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 285 (1959); Note, Tax-Free Sales in Liquidation under Section 337, 76 Harv. L. Rev. 780, 795-98 (1963).
contention has not prevented its acceptance in some quarters. In 1947
it was rejected by the Tax Court, but eleven years later, in Cohn v. United States, the Sixth Circuit accepted the Commissioner's argument; and when the question was relitigated before the Tax Court, it followed Cohn rather than adhering to its earlier decision. On appeal the Tax Court's decision was affirmed by the Second Circuit; but late in 1964 the Tax Court again reversed itself and ruled for the taxpayer. Hopefully, by early 1966 the problem will be resolved, for the Supreme Court has agreed to settle the question.

283. 259 F.2d 371 (6th Cir. 1958).
287. Certiorari was granted in Fribourg Nav. Co. v. Commissioner, 379 U.S. 998 (1965), and has been requested in United States v. Motorlease Corp., 33 U.S.L. WEEK 3203 (U.S. Nov. 13, 1964) (No. 685). While it is difficult to predict the course of action that will be taken by the Supreme Court, Judge Devitt sitting in S.&A. Co. v. United States, 218 F. Supp. 677, 685 (D. Minn. 1963), aff'd, 338 F.2d 629 (8th Cir. 1964), seems to have most clearly stated the correct conclusion:
It appears to me that the distinction drawn by the Tax Court is correct. [referring to Wies Long Leaf Lumber Co., 9 T.C. 990, 999]. It is plain from the decision that a sale of an asset at the end of its useful life for an amount in excess of its undepreciated cost at the beginning of the year of sale will justify a redetermination of salvage value. On the other hand, it is equally clear that the Tax Court held that sale of assets prior to the end of "useful life" at a price in excess of undepreciated cost at the beginning of the year of the sale does not justify a redetermination of salvage value because the excess of price over cost is mere appreciation in value.