Utilization of Subchapter S and Section 1244 Stock

L. Hart Wright
Utilization of Subchapter S and Section 1244 Stock

L. Hart Wright

INTRODUCTION

In 1958, Congress sought to assist small business by eliminating two of the most important federal tax differences previously existing between small corporate businesses and small non-corporate businesses. The ensuing statutory change left in its wake, inter alia, three major planning problems.¹

First, because Congress chose not to eliminate all the tax differences between the corporate and non-corporate forms, neutralizing instead only those it deemed most important, the tax advisor still must determine whether the remaining differences are sufficiently important in a given case to constitute a significant factor in making the ultimate choice of form.

Second, in an attempt to provide tax equivalence, Congress empowered a corporation to elect Subchapter S’s tax free status, with corporate income being taxed directly to the stockholders. An end to such status, and a return to regular tax practices associated with corporations, can come either through revocation — which requires unanimous consent of all stockholders — or, it can come automatically, even against the will of a majority, by a single stockholder’s unilateral act. Thus, the advisor who proposes use of such a tax-free corporation by two or more joint entrepreneurs must go on to suggest devices which will furnish adequate protection against a “termination” which otherwise might be brought about by one stockholder acting inadvertently or solely in his own self-interest.

A third planning problem requires the tax advisor to consider the merits of the second tax-equalizing method chosen by Congress (issuance of so-called section 1244 stock) so he can advise whether this method is to be preferred over the first, or is the only alternative available, or finally whether it should be used in addition to the first method.

Initial aspects of the first two of these three planning problems will be considered in a slightly different factual setting than that which will be used for an examination of the third problem.

¹ In addition, resort to Subchapter S will give rise to a host of minor planning problems, particularly with reference to distributions. See Wright & Libin, Impact Of Recent Tax Stimulants On Modest Enterprises, 57 Mich. L. Rev. 1131 (1959).
Utilization of Subchapter S

Initial Fact Situation

Messrs. Journalist and Financier have worked out tentative plans to acquire a building and the equipment essential to operate a newspaper in a small city.

Of the two, only Mr. Journalist plans to be active in the operation, serving as publisher. While he intends to commit practically all of his limited financial resources to the project, down-payment requirements are such as to make it necessary for Financier to make a much larger initial contribution, with the balance of required capital coming from loans negotiated with outsiders. This means, when the business finally reaches the stage when it can substitute black ink for red, that profits must be used for a significant period to discharge indebtedness.

Financier is already in a substantial tax bracket. He is vaguely aware of the advantages associated with the use of multiple corporations, particularly of the opportunity to devote more of an enterprise's profits to the discharge of indebtedness, by confining as much of the earnings as possible to the less burdensome thirty per cent bracket associated with small corporations. For this and other reasons, between the two men emerged the idea of establishing two corporations. One corporation would hold the land and buildings, and rent them to a separately incorporated company which would hold title to the equipment and operate the newspaper. While this complex organizational structure may make sense from a tax standpoint, with respect to a future profitable period, more immediate prospects point to a not insignificant initial operating loss, at least during the first year or two, i.e., until the enterprise really "catches on."

Initial Choice of Form as Affected by Subchapter S

Today, newly created joint enterprises which are expected initially to suffer operating losses need not be organized as partnerships to enable participating individuals currently to offset losses against their personal business or salary incomes. While the addition, in 1958, of Subchapter S to the Internal Revenue Code was intended, upon election, to free profitable qualifying "small business corporations"² from the federal corporate income tax³ (the quid pro quo being a current tax on stockholders with respect to the corporation's "undistributed taxable income" as well as its distributed profit⁴), a complementary aim was to allow

---

² Defined in INT. REV. CODE OF 1954, § 1371. (Hereinafter cited as §).
³ § 1372(a).
⁴ § 1373.
stockholders of a qualifying loss corporation to take current advantage of net operating losses.\footnote{5}

Both of the corporations proposed here technically satisfy the required characteristics of a "small business corporation" as described in Subchapter S. Both are domestic corporations, neither contemplates more than one class of stock nor will have more than ten stockholders, all of the stockholders are individuals (though an estate, but not a trust, would also qualify), and there are no non-resident, alien shareholders.\footnote{6} As a practical matter, however, only one — the operational unit — could in fact enjoy the benefits of that Subchapter's "pass-through" principle. An election by either, if consented to by all stockholders\footnote{7} and filed by the close of the first month of the taxable year,\footnote{8} would be theoretically effective for a time. However, the real estate corporation, as of the end of the taxable year, would run afoul of one of the automatic termination provisions, and these — unlike the revocation provisions\footnote{9} — will serve to neutralize the election retroactively, relating back to the beginning of that taxable year.\footnote{10}

There are four such automatic termination provisions,\footnote{11} three of which, according to our participant's contemplation, would not be an obstacle in the path of the realty corporation. These three relate (1) to the case where a corporation derives more than eighty per cent of its gross receipts in any one election year from sources outside the United States, (2) to cases where a new stockholder fails to file a timely acquiescence in a previously made election, and (3) to that circumstance where the corporation ceases to be a "small business corporation" as previously defined. The fourth terminating provision would, however, neutralize any attempted election by the real estate corporation; not more than twenty per cent of a company's gross receipts in an election year may be derived from certain non-qualifying domestic sources, these being, cumulatively, rents (here, the sole source), royalties, interest, annuities, and gain from the sale or exchange of stock or securities.\footnote{12}

If it is contemplated that the separate realty unit initially will also suffer a loss through, perhaps, an overzealous interest in declining balance depreciation, only if title is held in partnership or as tenants in

\footnote{5. § 1374.} \footnote{6. § 1371.} \footnote{7. § 1372(a).} \footnote{8. § 1372(c)(1). The election may also be filed during the last month preceding such taxable year.} \footnote{9. § 1372(e)(2).} \footnote{10. § 1372(e)(3).} \footnote{11. § 1372(e).} \footnote{12. § 1372(e)(5). It should be noted that the rules governing personal holding companies as to when rent is deemed personal holding company income do not govern here.}
common,\textsuperscript{18} can there be a pass-through of that loss.\textsuperscript{14} In our situation, however, the realty unit itself will not even initially be a loss operation; the indebtedness incurred in connection with the acquisition of the building included a requirement that the lease to be executed call for a reasonable rental from the outset.

\textit{Incidental Tax Advantages of Subchapter S Status Over Non-Corporate Forms}

In many cases, corporations which finally turn the profit corner will want to retain the pass-through privilege accorded by Subchapter S. Illustrative is a case, unlike ours, where all shareholders would suffer effective, as distinguished from marginal, rates not markedly different from what would be the effective corporate rate. And even if one or more of the shareholders would suffer a personal effective rate exceeding that which would be imposed on the corporation, the election may still be advantageous if it is contemplated, contrary to the expectations of Journalist and Financier, that a high percentage of the profits will be distributed annually, instead of, as in our case, being devoted to a discharge of corporate indebtedness.

It is in the setting of projected long range elections that certain incidental tax differences between a Subchapter S corporation and non-corporate forms take on the greatest significance. As previously noted, when Congress established so-called tax-free corporations by enacting Subchapter S, it left unaffected certain incidental tax differences which had existed between corporate and non-corporate forms.

These differences cover a wide range, and usually favor Subchapter S status if comparison is made with the proprietorship or partnership form. Looking first at organizational expenses, a Subchapter S corporation, like taxable corporations, may amortize that expense over a minimum five-year period.\textsuperscript{15} In contrast, the scanty authority available holds that the organizational expenses of partnerships must be capitalized and cannot be amortized during the operational phase.\textsuperscript{18}

Should one organizer be in the same position as Journalist, that is, planning active participation but lacking the resources necessary to buy

\textsuperscript{13} See Treas. Reg. § 1.761.1, distinguishing the situations in which a joint personal ownership leads to joint tenancy and in which it leads to partnership status. (Hereinafter cited as Reg.)

\textsuperscript{14} Of course, if the two units were parts of the same corporation, no rent would be paid and hence this problem would not arise. It is possible, given like circumstances, that the two units could merge and then invoke Subchapter S as described infra.

\textsuperscript{15} § 248.

\textsuperscript{16} Abe Wolkowitz, 8 CCH Tax Ct. Mem. 754, 772 (1949).
SUBCHAPTER S

a significant interest at the outset, stock options, which are available only in a corporate setting, may well solve the problem. Initial arrangements for their use will enable Journalist to maintain his proportionate interest in the equity and control of the business, and obtain certain complementary tax advantages.\(^{18}\)

Also, contrary to the case of a partnership,\(^{19}\) the Subchapter S corporation should have little difficulty in electing a tax year which differs from that of the principal stockholders. Indeed, by choosing a fiscal year which will normally begin on February 1, 1960, the undistributed profits attributable to the remaining eleven months of that calendar year would not constitute taxable income to calendar year stockholders until 1961, for profits are passed through only on the last day of the corporation's taxable year.\(^{20}\) The effect is to delay the due date for actual payment of any tax on undistributed profits by a year.\(^{21}\)

Another area where a Subchapter S corporation offers advantages over the non-corporate form relates to fringe benefits, which will constitute valuable "extras" so long as Congress leaves the door open to their tax-free use.\(^{22}\) Illustratively, a conflict has developed over whether a partnership which operates a motel or hotel may expense free board and room furnished the managing partner.\(^{23}\) In a Subchapter S corporation

17. See discussion pp. 218-23.
18. See, e.g., § 421 dealing with employee stock options.
19. § 706.
20. § 1373 (b). However, see § 1374 (b) and (c) for quite different rules relating to the allocation to stockholders of a net operating loss.
21. Income distributed during the eleven months of 1960 will be taxed to the calendar-year stockholders in 1960. Because excess capital gains retain their characteristics on being passed through, and are allocated to distributed as well as undistributed income, the difference in taxable years may require amendment of the stockholder's return for 1960 if capital gains are received by the corporation in January 1961. See § 1375.
22. In 1959, two bills were introduced in the House, H.R. 8683 and H.R. 9003, by Representatives Ikard and Mills, respectively, both of which would have amended Subchapter S by providing that a principal shareholder in a Subchapter S corporation could not be considered an employee thereof for the purposes of (1) employees' death benefits, (2) amounts received under accident and health plans, (3) contributions by employer to accident and health plans, (4) meals or lodging furnished for the convenience of the employer, (5) qualified pension, profit-sharing, and stock bonus plans, and (6) taxation of employee annuities. The bills were not reported out by the Committee on Ways and Means.
23. While certain Tax Court cases would permit a partnership operating a motel or hotel to expense free board and room furnished the managing partner, the Courts of Appeal for the Third, Fourth, Eighth, and Tenth Circuits have refused such permission. The Tax Court cases permitting this treatment include the following: R. E. Robinson, 31 T.C. 65 (1958), rev'd, 273 F.2d 503 (3d Cir. 1959); Everett Doak, 24 T.C. 569 (1955), rev'd, 234 F.2d 704 (4th Cir. 1956); G. A. Papineau, 16 T.C. 130 (1951), nonacq., 1952-2 CUM. BULL. 5; R. E. Moran, 14 CCH Tax Ct. Mem. 813 (1955), rev'd, 236 F.2d 595 (8th Cir. 1956); Leo B. Wolfe, 14 CCH Tax Ct. Mem. 791 (1955). Courts of Appeal decisions denying such permission include the following: Commissioner v. Robinson, 273 F.2d 503 (3d Cir. 1959), cert. denied, 363 U.S. 810 (1960); United States v. Briggs, 238 F.2d 53 (10th Cir. 1956); Commissioner v. Moran, 236 F.2d 595 (8th Cir. 1956); Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956). See also Rev. Rul. 53-80, 1953-1 CUM. BULL. 62 which laid down the position adopted by those four circuits.
setting, because the active participant becomes an employee, the corporate deduction and his exclusion are assured.25

For the same reason, more advantageous arrangements can also be made in the Subchapter S setting with respect to an active stockholder's old age. By the use of qualified pension or profit-sharing plans, the cost of which may be deducted by the corporation,26 the active stockholders, unlike partners, are permitted to defer tax on the amount put away.27 Indeed, there even are those who believe that a sole active proprietor, who is over sixty-five, could enhance his chance for immediate social security payments by incorporating and electing Subchapter S. The suggested device is to fix his salary at $1,200, the balance of the profits being taken out as dividends. The supporting argument is to the effect that while the Internal Revenue Service is prepared to scrutinize, skeptically, unreasonably high salaries,28 it presently does not have decisional authority to challenge a salary as being unreasonably low in the light of services performed,29 unless the arrangement in effect results in deflection of income to other persons.30 Moreover, if the sixty-five-year-old active sole stockholder is ineligible for O.A.S.I. benefits for other reasons, it has also been suggested that this same device can be used in connection with the complementary retirement income credit.31

Another advantage available to active stockholders, but, again, not to partners, relates to medical and hospital care insurance. As corporate employees, a plan could be worked out which would allow the employer-corporation to deduct the cost of premiums to provide such insurance coverage while the stockholder-employees could exclude such benefits from their taxable income.32

Tax-free wage continuation plans in case of accident or illness are also

24. § 162.
25. § 119.
26. See § 401.
27. Ibid. This would provide a particular advantage to certain professional persons, such as architects, who previously avoided incorporation because of personal holding company difficulties under §§ 541-547 which now would not seem applicable to Subchapter S corporations.
28. Pursuant to the expressed limitation of reasonableness in § 162.
29. Pat O'Brien, 25 T.C. 376 (1955). In the case of proprietors under sixty-five, incorporation and election of Subchapter S will eliminate the self-employment tax, the substitute being a division of the social security tax between corporation and stockholder-employee, with the corporation deducting the payment it makes.
30. § 1375(c) gives the Commissioner power to apportion or allocate income between shareholders who are members of a family group if he determines such apportionment or allocation necessary "to reflect the value of services rendered to the corporation by such shareholders."
31. § 37.
32. § 162.
33. §§ 105 and 106. See also Reg. § 1.61-2(d) (2). It should be recalled that partners are not considered employees, and hence are not eligible for such benefits on a tax-free basis. See Rev. Rul. 56-326, 1956-2 CUM. BULL. 100.
available for stockholder-employees, but not to the members of a partnership.

Stockholder-employees, but not partners, could also exclude premiums paid by the business for group term life insurance. But this assumes a sufficiently large group to make such a plan practicable, with the consequent costs that such an arrangement would entail. Such insurance, however, is not the only so-called “extra” which might entail costs in excess of the benefit moving directly to the principals. The non-discrimination requirement associated with the previously mentioned pension and profit-sharing plans may also create expenses disproportionate to benefits.

The final tax advantage of a Subchapter S arrangement over a partnership form can be shown by the example of a profitable but non-expanding business which was subsumed under Subchapter S because the principals anticipated a full distribution of all profits at the close of each year. If one of the principals desires to give all or part of his stock to other members of his family, a mid-year gift would even shift the income tax incidence with respect to income earned that year. This is because profits not distributed prior to the year’s end are passed through only at the year’s end, and only to the stockholders at that time. Subchapter S does, however, include a special policing provision authorizing the Commissioner to reallocate income among related persons if services rendered by a related person to a Subchapter S corporation are not adequately compensated.

It must also be remembered that if the gift is in trust, the Subchapter S status will terminate, since the introduction of a trustee as a stockholder removes the corporation from the “small business corporation” category. If the trust was considered expedient only because of the minority of the beneficiary, a gift to a statutory custodian for his benefit may be a satisfactory alternative, and it will not cause a termination of the corporation’s tax status.

Disadvantages of Subchapter S Status When Compared to Non-Corporate Forms

Until now, only the advantages of a Subchapter S arrangement over the proprietorship and partnership forms have been considered. There are also disadvantages.

34. § 105(d).
35. See note 32 supra.
37. § 1375(b).
38. § 1375(c).
39. Reg. § 1.1371-1(d).
40. OHIO REV. CODE §§ 1339.19-.28.
The first is most dramatically illustrated when the comparison is to a proprietorship, and arises from the fact that a Subchapter S arrangement does call for incorporation with its attendant costs.

A second, but easily exaggerated, shortcoming relates to the fact that the pass-through principle is not applied to all items, as it is in the partnership form. For instance, provision has not been made for a pass-through of any capital losses which a corporation may have suffered. The importance of this disadvantage is markedly reduced when realistic account is taken (1) of the role of section 1231, pursuant to which sales of depreciable property are likely to result in ordinary loss or capital gain, and (2) of the fact that ordinary losses do pass through and that capital gains, on passing through, do retain their preferential characteristics.

Finally, incorporation, necessary to receive Subchapter S treatment, may increase and will complicate the enterprise's local or state tax burdens. For example, whether or not it is a profitable business, a Subchapter S corporation in Ohio would be subject to the state's annual corporate franchise tax. Also brought into play would be the state intangibles tax, equal to five per cent of all dividends. This fairly simple state tax becomes complicated with the interpretative question of whether the word "dividend" includes only amounts actually distributed or embraces also the corporation's "undistributed taxable income" which federal law taxes directly to the stockholders. It is easy to understand why the Ohio Department of Taxation has not always "hewn a straight path" with regard to the matter.

Most cities in Ohio, on the other hand, have avoided one complication which has arisen elsewhere. For example, the Toledo income tax is applied to pre-federal-tax profits. If it were otherwise, the knotty question would arise as to whether a corporation could take a deduction for a federal tax which it does not in fact pay, the federal assessment

42. § 701.
43. § 1374(b).
44. § 1375(a).
45. OHIO REV. CODE ch. 5733.
46. OHIO REV. CODE §§ 5707.03, 5705.04, 5709.02.
47. Initially the Ohio Department of Taxation held that the intangibles tax on stock in a Subchapter S corporation is measured by the full amount of the dividends reported for federal tax purposes, whether or not received by the stockholder. Subsequently, in OHIO DEPARTMENT OF TAXATION BULLETIN No. 137 (1959), the Department reversed its position and held that actual receipt of dividends is necessary to produce investment income under the intangibles tax. In a letter dated January 7, 1960, however, the Department stated a still different position, namely that taxpayers using the federal election will be taxed on the basis of dividends reported for federal tax purposes, whether or not received, but that taxpayers not employing the federal election will be taxed only on the basis of dividends actually received. 1 CCH OHIO TAX REP. ¶ 20-330 (1960).
48. City of Toledo Income Tax Return, Schedule X. See also the General Instructions for filling out the return, paragraph VI.
actually being against the stockholders. In other locales where taxpayers do face this problem, the deduction might be lost to one and all.49

Advantages and Problems in Shifting an Old Corporation in or out of Subchapter S

To limit comparison of Subchapter S to the non-corporate forms distorts its overall function. Frequently, it should be compared also to regular corporate tax status, for example, in trying to decide whether an old taxable corporation should be shifted under the immunizing shield provided by Subchapter S, or, if already under that subchapter's protective arm, whether the enterprise should be shifted back to regular corporate tax status.

Sometimes, as previously noted, such a question may be easily resolved by comparing effective corporate tax rates with what may be the lower effective personal rates applicable to the interested individuals.

Apart from cases which may be resolved on the basis of rate comparisons, but equally simple to resolve, are those in which the stockholders of a profitable and taxable corporation have decided to forego further expansion and plan to distribute all future profits. An election under Subchapter S will avoid the so-called double tax without incurring tax costs normally associated with liquidation of a corporation into a partnership.50 Indeed, where there is no plan for further expansion, just such an election may be the best method to shield the corporation from the section 531 penalty tax which otherwise might be incurred with reference to future unreasonable accumulations of profits.

Again, in connection with a decision to liquidate what has been a regular taxable corporation, the entrepreneurs may decide that the plan should be complemented by a Subchapter S election, the aim being to avoid the corporate tax on disposition of the assets without having to comply with the detailed requirements of section 337.51 Such an election might be made to facilitate an installment sale by the corporation of those assets, an arrangement not easily accommodated under section 337.

A more difficult decision is involved in trying to decide whether an old taxable corporation should invoke Subchapter S in order to effect a

50. Even if § 337 is availed of to immunize the corporation at the point of liquidation, § 331 would reach any gain realized by the stockholders.
51. Proposed Reg. § 1.1372-1(a) (2), stated that a corporation was not eligible to make a Subchapter S election if it was in the process of complete or partial liquidation, had adopted a plan to that effect, or contemplated liquidation or the adoption of such a plan in the near future. This particular portion of the Proposed Regulations was not included in the Regulations as finally issued.
pass-through of an anticipated corporate operating loss.\textsuperscript{52} One may need recourse to a crystal ball as well as skill in mathematics. Need for the former arises out of the fact that an election to subsume the corporation under Subchapter S must be made, at the latest, by the close of the first month of the taxable year to which it is to relate.\textsuperscript{53} Thus, one must decide in advance whether an operating loss will in fact be suffered during the ensuing year, and if so, whether eventually there will be corporate profits against which it could be applied on a carryforward basis. Crystal-gazing accomplished, mathematics takes over to answer which would be more attractive: a net operating loss carryforward by the corporation itself or an immediate pass-through which would be accomplished through a Subchapter S election.\textsuperscript{54}

Assuming an election is made, at some later point an advisor may have to face the even more difficult question which also confronts our Messrs. Journalist and Financier. In their case, the initial election was made only to facilitate a pass-through of the operating loss; when the business enters a profitable stage, the bulk of all profits must be devoted to the discharge of indebtedness and it will be to Financier's advantage, because of his own personal high tax rate, to see that the election under Subchapter S is revoked in a timely fashion. A revocation, like an election, must be made by the close of the first month of the year to which it is to relate,\textsuperscript{55} and thus requires a rather careful prediction as to the business outlook. If an election is revoked, and the prediction of a profitable future turns out to be inaccurate, the corporation will be in the awkward position of being unable to re-invoke Subchapter S's pass-through privilege until the fifth succeeding year.\textsuperscript{56}

\textsuperscript{52} An anticipated personal business loss by a sole stockholder may also make it desirable to invoke Subchapter S for a short term, the aim being to apply retained corporate profits against that loss.

\textsuperscript{53} § 1372(c). It should be noted that election can be made during the month preceding the first month of any taxable year as well as during the first month itself. Reg. § 1.1372-2(a) sets out the mechanics of making such an election. The corporation must file with the appropriate district director Form 2553, signed by any person authorized to sign the income tax return required under § 6037, containing the required information. The corporation must also file a statement of the consent of each stockholder in the corporation. It should be noted that all stockholders must consent to the election.

\textsuperscript{54} If a regular taxable corporation had been suffering net operating losses, and Subchapter S is invoked to facilitate a pass-through of anticipated future losses, an unexpected shift by the corporation into the profit column will also be embarrassing, for the earlier corporate losses cannot be applied against the passed through profits.

\textsuperscript{55} § 1372(e)(2). Revocation of an election requires the consent of all persons who are stockholders on the day of revocation. Revocation is effected by filing with the appropriate district director a statement (1) to the effect that the corporation revokes the election previously made, (2) indicating the first taxable year of the corporation for which the revocation is intended to be effective, and (3) signed by any person authorized to sign the income tax return required under § 6037. Attached to the statement of revocation should be a statement of consent signed by all persons who are stockholders at the beginning of the day on which the statement of revocation is signed.

\textsuperscript{56} § 1372(f).
Retroactive Revocations Accomplished by Resort to the "Termination" Provisions

Where, because of uncertainty regarding the business outlook, it is not clear at the beginning of a year that an election should be revoked, the stockholders could effect a termination of Subchapter S treatment near the year's end, when the result of that year's operations is more easily predictable, by acting in such a way as to bring about an automatic "termination." The latter, unlike a revocation, does relate back to the beginning of the taxable year in which the operative act occurred. But the operative acts which can effect a termination are not the kind which all stockholders would necessarily approach with great enthusiasm. As we shall later see in more detail, they include such fairly drastic matters as introduction of a new shareholder who foregoes filing a timely consent to the existing election.

Reorganizing Corporate Affairs on a Tax Free Basis to Qualify for the Election

Some existing corporations which might prefer to elect Subchapter S treatment may be ineligible for a reason curable by reorganization — an adjustment which might be approached more enthusiastically if it could be handled on a tax-free basis. For instance, the corporation which falls short of Subchapter S's standards because two classes of stock are outstanding might rid itself of the outstanding preferred by recapitalizing under the tax-free provisions of sections 368(a)(1)(E) and 354. Another corporation owning realty which produces rents somewhat in excess of twenty per cent of corporate gross receipts could resort to the tax-free divisive reorganization provisions of sections 368(a)(1)(D) and 355 in order to transfer the realty to a newly created corporation. Even then, of course, only the old corporation could qualify under Subchapter S. The final illustration is opposite to that just mentioned and poses a type of problem our original Messrs. Journalist and Financier may someday face. Involved is an enterprise which began life divided into two corporations with common ownership. One corporation held title to buildings and land which it rented to the second, an operating company engaged in publishing a small newspaper. While the entrepreneurs could easily

57. § 1372(e).
58. Ibid. Although Reg. § 1.1372-4(b)(3) provides that an eleventh stockholder will cause an automatic termination of the election, there is a suggestion in Reg. § 1.1372-3(b), relating to the required consent by a new stockholder if the election is to continue, that such transfers of stock to new stockholders or the sale of new stock to a new stockholder are expected to be bona fide transfers and not transfers of a single share with the intent of thereby causing an automatic termination if a consent is not filed. The Regulation requires that the consent of the new stockholder set forth — among other matters — the number of shares owned, the date acquired, and the name and address of each person from whom they were acquired.
qualify the operating company, they could instead effect a tax-free merger under sections 368(a)(1)(A) and 354, the aim being to subsume both facets of the operation under Subchapter S by eliminating the rental arrangement.

Advisors in all three of the foregoing cases will focus attention, of course, on the question of whether the so-called business purpose doctrine or its offspring will close off tax-free corridors otherwise available under the reorganization provisions. Of concern is the fact that the adjustment in the corporate complexion would be undertaken not for an ordinary business purpose, but instead only to enable the corporation to be free of the federal income tax with respect to future operations. Because of the complexity of this issue, only this can be said here: as noted elsewhere, there are good though not definitive reasons to believe the business purpose doctrine is not a really serious obstacle.

Planning Ahead to Prevent Unanticipated or Premature Termination of Election

A decision to file an election under Subchapter S should be complemented with plans to avoid unanticipated or premature termination of the election through some unfortunate disqualifying action taken by a stockholder acting either inadvertently, because badly advised, or in his own self-interest.

Such a termination would result in the corporation's loss of its tax free status as of the beginning of that taxable year. As a consequence, corporate rates would apply even to what may have been an unusual gain realized in the early part of the year by the corporation, the added exaction being, perhaps, to the very real detriment of the other stockholders. Distributions previously made in that year will also be subject to an additional tax as dividends. Moreover, such a corporation is barred from re-electing Subchapter S treatment until the fifth succeeding taxable year. Finally, undistributed taxable income which had been retained by the corporation in earlier years, but on which the stockholders have already paid the tax, may be entrapped, for that income may not now be distributed tax free until all current earnings and profits have been distributed and taxed as dividends.

59. Note 61, infra.
60. Ibid.
62. § 1372(e).
63. §§ 301 and 316.
64. § 1372(f).
65. § 316.
The Terminating Events

Events which are within the separate control of each stockholder and which automatically would lead to termination of the election include the following:

(1) A transfer to a new non-consenting shareholder, i.e., an inter vivos or testamentary transfer to a new shareholder (including an executor as well as an ultimate transferee) who fails or refuses to file a timely consent to the existing election;

(2) A transfer to a disqualifying type of shareholder, i.e., an inter vivos or testamentary transfer to one other than an "individual or estate" (such as a trustee);

(3) A transfer to a supernumerary shareholder, i.e., an inter vivos or testamentary transfer which results in the corporation having more than ten shareholders; and

(4) The event of an existing shareholder becoming a non-resident alien, or of his making an inter vivos or testamentary transfer to such a person.

The Protective Plan

To avoid the consequences of unanticipated termination and to guard against the situations which could cause it to arise, a carefully worked out plan is essential. In designing such a plan, the advisor's obvious aims are (1) to protect the integrity of the election — assuming that is what the stockholders want — and (2) to meet a standard of reasonableness — avoiding that which would be unduly harsh. For instance, account should be taken of the fact that some of the stockholders very possibly may occupy quite different income tax positions in the future than they do at present. An election which was initially satisfying to all may some day be satisfying only to some and be very much against the self-interest of others.

A suitable plan might include three features: First, it could restrict inter vivos and testamentary transfers of stock, giving a first option at such points to the corporation according to some agreed valuation formula and then a second option to the other stockholders on a pro rata basis. Second, it might seek to bind each shareholder to include in his will an authorization, or perhaps a direction to his executor to file a timely consent (within thirty days after qualification), the aim being to relieve the executor from seeking to determine whether such action is in the best interests of the estate. If there is to be any hope that such agreement will be binding, the agreement should be executed in such a manner as to comply with local statutes relating to the execution of docu-

66. Reg. § 1.1372-3 (b).
ments which may be incorporated by reference in a will.\footnote{67}{\textit{Ohio Rev. Code} \S\ 2107.04 validates an agreement to make a will upon compliance with certain formalities. \textit{Ohio Rev. Code} \S\ 2107.05 permits a will to incorporate by reference a document, record, or memorandum.} \textit{Finally}, it may be desirable to include some kind of provision relating to dividend policy, the aim being to accommodate the fact that shareholders, by virtue of the election, will have to pay individual income taxes even on undistributed profits.

In the normal case, the format will first be worked out in a restrictive agreement, \textit{i.e.}, a contract executed by the shareholders, purporting to bind their heirs, executors, administrators, and assigns by requiring all such parties to execute such instruments or take such action as may be necessary in order to comply with the agreement. Fortunately, the Ohio statutes make it clear that restrictions on the right to transfer stock may be included in the regulations governing a corporation.\footnote{68}{\textit{Ohio Rev. Code} \S\ 1701.11 (B) (8).} However, by virtue of the Uniform Stock Transfer Act, which has been adopted in Ohio,\footnote{69}{\textit{Ohio Rev. Code} \S\S\ 1701.25, 1705.18.} such restrictions, to be enforceable, \textit{must} be noted conspicuously on the face of the stock certificate itself. In addition, it may also be possible through extra-judicial devices to further the prospect of compliance. A provision could be added to the articles of incorporation to the effect that shares transferred in violation of the restrictions shall be denied voting and dividend rights until such time as the shares are offered to the corporation or other stockholders pursuant to the option.\footnote{70}{Such a provision would give rise to one danger: the Treasury might hold that the effect is to create a second class of stock, thus terminating the election. Competing with any such contention is the notion that \textit{initially all} of the stock will carry the same conditional restriction; it could be argued that two classes will actually emerge only when and if certain specified terminating events occur.}

**FUNCTIONAL RELATIONSHIP OF SECTION 1244'S "SMALL-BUSINESS-STOCK" ARRANGEMENT TO SUBCHAPTER S'S ARRANGEMENT**

**Basic Purpose of Section 1244, and Its General Relationship to Subchapter S**

Not all small enterprises will want, or be able to satisfy the requirements of, Subchapter S. Illustrative is the plan of fifteen prospective shareholders to open a stamping plant, the bulk of its product to go to a major manufacturer under terms which seem to offer an attractive profit margin. Of the fifteen, some will hold common stock, others preferred. Even with the prospect of a profitable beginning, these entrepreneurs realize the potential pitfalls of their dependence on one customer, a situation which is aggravated by the cyclical nature of his business. Hence,
they want to share their risk with the Treasury Department in as great a
degree as possible. The fact that there are more than ten stockholders or,
alternatively, that financial requirements forced issuance of two classes
of stock, would close the door on the possibility of invoking Subchapter S
should a loss period be encountered. However, more of their risk than
formerly, may now be shifted to the Treasury by some, though not all,
of these stockholders through a companion provision, section 1244,
which Congress adopted at the time it designed Subchapter S.

The basic purposes of section 1244 differ from those of Subchapter S in four essential respects.

First, whereas Subchapter S constituted a new approach to profitable
and loss operations alike, (although a corporation could elect a pass-
through at one stage and not the other), section 1244 represents a new
approach only to loss operations. It will be useful only if trouble is
encountered.

Second, when one looks only at the loss side, he will note that there
is another difference, in terms of the respective times at which the effect
of the two arrangements can be sprung into operation. Whereas Sub-
chapter S permits operating losses to be deducted by the stockholders
currently, i.e., as they are incurred by the corporation, section 1244 post-
pones the stockholder's right to avail himself of its benefit until such time
as the corporation is liquidated or he sells or exchanges all or part of his
stock; at such point the loss, within certain limitations, may be treated
as an ordinary loss which, unlike the capital loss previously available, is
fully deductible from other ordinary income. In the sense only of this
quality which will be assigned to the loss for tax purposes, both of the
new arrangements, within their respective limits, neutralize a difference
which previously existed between corporate and non-corporate forms.
But as previously noted, unlike Subchapter S, the benefit of section 1244
is actually realized only if and when the stockholder modifies his interest
in the corporation.

Third, section 1244 was engendered by the 1958 recession, and
therefore it was linked more intimately than Subchapter S with stimula-
tion of new job producing investments through reduction in the tradi-
tional risk borne by investors in small enterprises. While Subchapter
S's pass-through of a loss can be availed of by those who acquired their
stock in years long past, section 1244 relates only to new stock, issued
for property or money pursuant to a plan adopted after June 30, 1958.

---

71. Before the adoption of § 1244, ordinary loss treatment was confined to promoters,
though, in the case of others, any capital loss in excess of capital gains could be offset against
ordinary income to the extent of $1,000 or taxable income, whichever was less, with a five-year
carryover right. See §§ 1211(b), 1212.

72. Unlike stockholders themselves, non-corporate forms could rely, inter alia, on § 1231.
Finally, as is more fully indicated below, the two also differ with reference to their respective qualifying standards, for example, the diverse meanings which each assigns to the qualifying category, "small business corporation." Even with these differences, section 1244 is complementary as well as supplementary. There is an area of overlap between section 1244 and Subchapter S, and within that area an election under Subchapter S might be complemented by section 1244 stock, in which case this second arrangement takes on the role of a secondary insurance policy.

Types of Qualifying Requirements under Section 1244

Congress confined the coverage of section 1244 by reference to four facets of corporate existence. Standards were imposed with respect to the character of the corporation, the section 1244 issue itself, and the amount of loss which would be allowed as a deduction.

Required Character of the Corporation

The required characteristics of the corporation itself relate to its nationality, its financial structure, and its gross receipts.

Like Subchapter S, section 1244 requires that the corporation be domestic. But whereas Subchapter S sets a limit on the number of shareholders, no statutory attention being directed to the dollar amount of capital, the exact reverse is true under section 1244. The focus on just small business was accomplished here by confining eligibility to corporations which, as of the date a section 1244 plan is adopted, will have a total equity capital of $1,000,000 or less. Moreover, that overall ceiling relates to the aggregate of previously issued stock, the planned issue of section 1244 stock, and any indebtedness running to the shareholders. Also, unlike Subchapter S, the total equity capital may include preferred as well as common stock, though the preferred itself could not qualify for section 1244 treatment. A second maximum dollar limitation relates to section 1244 issues themselves, the ceiling here being $500,000.

Limitation to a kind of business activity which Congress sought to stimulate was accomplished by the imposition of standards relating to the nature of gross receipts. But, unlike the preceding limitations, the applicability of this standard cannot be determined, at least theoretically, at the time section 1244 stock is issued. However, as a practical matter, the entrepreneurs' own conceptions of the corporation's future activities

73. Another difference between the two arrangements relates to indebtedness running to otherwise qualified stockholders. A § 1244 loss may not ever exceed the stockholder's basis in § 1244 stock, whereas losses under Subchapter S may be passed through to the extent of the stockholder's basis for his stock and indebtedness. § 1374(c).
will normally enable them to predict whether qualification will exist on the pivotal dateline, i.e., the point of time when their individual losses are realized through sale, etc. Only in the exceptional case will it be difficult at the point of initial planning to predict the nature of the corporation's gross receipts during the statutory standard *five-year period* preceding any loss claimed under section 1244 (or where the corporation has been in existence for less than five years during the period of corporate existence). In any event, any such loss will not qualify if during that multi-year period over fifty per cent of corporate gross receipts came from rent, royalty, dividends, interest, annuities, or gain from the sale or exchange of stock or securities.\(^7\)

Requirements Relating to the Section 1244 Issue Itself

As previously noted, Congress was not willing to go so far as to qualify the entire stock issue of a new $1,000,000 small business corporation; it placed a dollar limit — $500,000 — on the amount of section 1244 stock that may be issued.

Moreover, its intent to have the Treasury bear a greater share of any loss was limited to those who undertake the greatest risk; qualifying stock is limited to *common* stock, whether voting or non-voting, but not common stock which is convertible into something else.\(^5\)

The intention to stimulate risk-taking also led to the notion that only stock issued for “money or other property” could qualify;\(^6\) stock issued for services will fall short of the mark. Indeed, the 1958 recession-minded Congress intended to confine this new tax break solely to *original* risk-takers who first venture capital in *new* or expanded business activity. Thus, unlike the case under Subchapter S, only stock issued pursuant to a plan adopted *after* June 30, 1958, can qualify. And even then, only the *original* risk-taker, i.e., the same stockholder whose money or property actually made possible the new or expanded business activity, may enjoy the benefit of section 1244.\(^7\) Thus, unlike Subchapter S, donees and legatees, as well as subsequent vendees, may not qualify. Nor can a shareholder convert *non-qualified* stock into qualified stock by transferring the former to the same or a different corporation in exchange for

---

\(^{74}\) In more or less borderline cases, it may be desirable, where a corporation is over the 50% mark, to have it dispose of the nonqualified type of income-producing property a year or two before the stockholder modifies his interest, thus changing the average over the five-year span. Note also that Reg. § 1.1244(c)-1(g) (3) (iii) excludes from the definition of "rents" amounts received for the use of property if significant services are also rendered, as in the case of occupancy of rooms in motels and hotels.

\(^{75}\) Reg. § 1.1244(a)-1(b).

\(^{76}\) § 1244(c) (1) (D). With respect to problems which arise on transferring appreciated property in exchange for § 1244 stock, see Nicholson, *Section 1244 Stock*, 38 *TAXES* 303, 319-22 (1960).

\(^{77}\) Reg. § 1.1244(c)-1(b).
what might otherwise be qualified section 1244 stock. "Money or other property," which must serve as the *quid pro quo* for a section 1244 offering, does not, for purposes of this provision, include "stock or securities." Moreover, the class of qualified original risk-takers itself was limited to individuals, including partnerships. Trusts and estates, as well as corporation-stockholders, have been rendered ineligible under section 1244. Here there is a closer analogy to Subchapter S which forecloses the right to file an election if trusts or corporations, though not estates, are included among the shareholders.

Since Congress was interested in new business activity, not necessarily new corporations, either a new or old corporate entity may qualify a new issue. In part because only $500,000 may be qualified, (although total equity capital, as previously defined, may run to $1,000,000), earmarking is required. This is accommodated by the requirement that the stock to be qualified must be issued pursuant to a plan.

Such a plan should be adopted by a formal action on the part of whatever group possesses the authority to issue stock. The action should take place at a meeting of such persons and should be evidenced in some document. This document should be dated and should state specifically (1) the maximum dollar amount to be received by the corporation for the stock and (2) the period of time within which the offer is to remain open — which in any case cannot be for over two years, running from the date of the adoption of the plan. Certainly the plan should indicate an intention that the stock qualify under section 1244.

At the time the plan is adopted, no portion of a prior stock offering may be outstanding. This will not pose any problem, of course, to investors who are activating a new corporation. But if they are stockholders of an existing corporation which plans a section 1244 issue, they may find their proposal is complicated by the existence of outstanding rights, warrants, or stock options.

---

78. However, the statute does authorize the treasury to fix rules relating to continued qualification where the shareholder's original stock was § 1244 stock. See Reg. § 1.1244(d)-3(a).
79. However, a partner who enters the firm after the partnership acquired the § 1244 issue does not qualify.
80. See § 1371(a) (2).
81. Although the statute itself does not require that such a plan be reduced to writing, the committee report (H.R. Rep. No. 2198, 85th Cong., 2d Sess. 8 (1958)) states that "such plan must be in writing" and the Regulations incorporate this requirement (Reg. § 1.1244(e)-1(c)).
82. Both the committee report (H.R. Rep. No. 2198, 85 Cong. 2d Sess. 12 (1958)) and Regulation § 1.1244(e)-1 emphasize the importance to the corporation of keeping detailed and adequate records to support an ordinary loss deduction claimed under § 1244. While it is true that the claims for losses will be made by individuals, nevertheless, the satisfaction of the technical requirements lies primarily within the control of the corporation.
83. Light is thrown on the meaning of the word "offering" by the language of the Regulation, § 1.1244(c)-1(e), which states: "[S]tock rights, stock warrants, stock options, or securities convertible into stock which are outstanding at the time the plan is adopted are..."
As a complement to the rule that no prior stock offering may be outstanding at the time section 1244 stock is issued, section 1244 stock may not be issued after a subsequent stock offering is made. Corporate advisors must remember that, should non-qualifying stock be issued after only part of an issue intended to qualify under section 1244 has been issued, the section 1244 stock issued subsequent to the intervening stock offering will be disqualified.

Limitations on Amount of Allowable Loss

In deciding when to realize through sale, exchange, or liquidation an unrealized loss in section 1244 stock, some taxpayers may need to take into account, inter alia, the limitation Congress placed "on the aggregate amount of loss" which may be taken under this section in any one year. In equating common law and community property states, the $25,000 yearly ceiling on the loss deduction allowed one taxpayer is hiked to $50,000 in the case of married couples filing a joint return. If any excess is realized during a particular taxable year, it is treated as capital loss.

A taxpayer with an unrealized loss in excess of the ceiling may try, of course, to spread his sales over more than one year, for the limitation applies only to the aggregate in a given year, and whether suffered on investments in one or more corporations.

Taxpayers whose only problem is that their ordinary income in a given year is not large enough to consume the entire deduction which is allowable have a less difficult problem. The excess portion of the allowable loss may be carried back and forward as a net operating loss.

deemed to be prior offerings. The authorization in the corporate charter to issue stock different from stock offered under the plan of itself is not a prior offering."