Volume 17 | Issue 3

Article 6

1966

Recent Developments Affecting the Choice of a Business Organization

Zolman Cavitch

SELECTED PROBLEMS IN GENERAL PRACTICE

Attorneys are becoming increasingly aware that tax considerations must be taken into account in the determination of most financial matters. Three areas which offer numerous opportunities for tax saving are discussed in this section. Mr. Zolman Cavitch analyzes the tax advantages and pitfalls which accompany the choice of certain forms of business organizations. He concludes that tax factors will often indicate the desirability of a Subchapter S election or a limited partnership arrangement. Mr. Edward A. Eisele, Jr. discusses the possibility of an incorporated real estate business being treated as a collapsible corporation for income tax purposes. After tracing the effect of recent cases upon this area of the law, the author analyzes the specific problems attending the purchase of vacant land and old buildings. Mr. Charles W. Landefeld treats the income tax aspects of estate administration. He concentrates his efforts on the problem of income splitting and gives special attention to the details of an estate's income tax return.

I

Recent Developments Affecting the Choice of a Business Organization

Zolman Cavitch

SUBCHAPTER S of the Internal Revenue Code enables certain corporations to elect not to be subject to federal income tax.[1] This important tax innovation was first enacted seven years ago. The conclusion is now inescapable that the possible virtues of a Subchapter S election are many and varied.[2] But seven years of experience with Subchapter S have also shown that the technical requirements for electing and maintaining Subchapter S status are unnecessarily complex and restrictive. The purpose of this article is to emphasize the importance of avoiding some of the common pitfalls existing in the area of Subchapter S.

THE AUTHOR (A.B., LL.B., University of Michigan) is a practicing attorney in Cleveland, Ohio and is a Lecturer in Law at Western Reserve University.

---

[1] INT. REV. CODE OF 1954, §§ 1371-77 [hereinafter cited as CODE §].

[2] See OUTLINE FOR PROCEEDINGS OF THE SIXTH ANNUAL CLEVELAND REGIONAL TAX INSTITUTE 116 (1963); OUTLINE FOR PROCEEDINGS OF THE SECOND ANNUAL CLEVELAND REGIONAL TAX INSTITUTE 81 (1959).

I. AVOIDING THE PITFALLS OF SUBCHAPTER S

A. *Timely Filing of the Corporation's Election*

The first, and perhaps the most important, observation is that a neurotic attitude must be cultivated towards the importance of meeting the various time requirements. A corporation's election to come under Subchapter S *must* be filed within the first month of the taxable year for which it is to be first effective, or in the immediately preceding month.[3] There is no latitude whatever for this particular requirement. An election filed either too late or too early is clearly ineffective.[4]

B. *Timely Filing of the Shareholders' Consent*

The corporation's election is effective only if the written consent of all shareholders is also filed.[5] With respect to shareholders who are such when the election is made, their consent must ordinarily be filed within the same time limitations applicable to the corporation's election.[6] Ordinarily, that consent will be filed with the corporation's election.

A person who becomes a new shareholder after the consents of the original shareholders are filed must also file a consent, ordinarily within thirty days, or the Subchapter S election is lost to everyone.[7]

In some instances, however, the time requirements for filing shareholder consents are no longer applied with absolute strictness. Under certain circumstances the District Director's office is authorized to grant retroactive extensions of time for filing consents.[8] Thus, late consent will ordinarily be accepted if (1) reasonable cause can be shown for the failure to file on time, (2) the government will not be jeopardized by the omission, (3) the tardy shareholder files a proper consent within the extended time, and (4) new consents are filed by all persons who were shareholders at any time during the relevant taxable year and up to the date of the extension.

---

[3] CODE § 1372(c).

[4] Simons v. United States, 208 F. Supp. 744 (D. Conn. 1962); J. William Frentz, 44 T.C. 485 (1965); William Pestcoe, 40 T.C. 195 (1963).

[5] CODE § 1372(a).

[6] Treas. Reg. § 1.1372-3(a) (1959), as amended, T.D. 6707, 1964-1 CUM. BULL. 315 [hereinafter cited as Reg. §].

[7] *Ibid.* A decedent's estate is a new shareholder, but the 30-day period does not ordinarily begin until the executor or administrator is appointed. Reg. § 1.1372-3(b) (1959), as amended, T.D. 6707, 1954-1 CUM. BULL. 315; Rev. Rul. 116, 1962-2 CUM. BULL. 207.

[8] Reg. § 1.1372-3, (1959), as amended, T.D. 6707, 1964-1 CUM. BULL. 315.

Clearly, this recent liberalization in the time requirements should not encourage a lackadaisical attitude towards the normal time limits. There is still no latitude whatever for filing the corporate election, and even in regard to shareholder consents the District Director has some degree of discretion. The time requirements still represent a pitfall, but a significantly less treacherous one than they were during the first few years after the enactment of Subchapter S.

C. *The Danger of Shareholder Loans Being Considered Stock*

The possibility that the Internal Revenue Service might consider a shareholder loan to the corporation to be a separate issuance of stock poses a problem which presents the business advisor with an important judgment determination. A Subchapter S election cannot be made, or if made, will automatically be terminated, if the corporation has more than one class of stock outstanding.[9] The Treasury has consistently taken the position that where a corporation issues instruments which purport to be debt instruments but, for one reason or another, are not treated as debt instruments for income tax purposes, they will be considered a second class of stock, thereby disqualifying the corporation from Subchapter S status.[10] Recent cases support the Treasury's position.[11]

The foregoing emphasizes the importance of two quite different determinations. First, should a Subchapter S corporation ever be thinned? That is, when a new, *conventional* corporation is being formed and a substantial amount of assets are put into the corporation, it will usually be good business planning to thin the corporate capital. This will ordinarily be accomplished by causing the corporation to issue debt instruments as well as stock to the investors. If the debt instruments are upheld as valid, the tax benefits obtained by thinning, particularly the benefit of enabling the shareholder-creditors to withdraw from the corporation a substantial amount of their initial investment as a tax-free return of capital, are indeed impressive. In recent years, case law has made the validity of this technique less certain; with increasing frequency, the decisions have a subjective reaction of the particular judge rather than an analysis of objective criteria. Notwithstanding this element of uncertainty, if care is taken at the planning stage, thinning is still a desirable

---

9 CODE § 1371(a)(4).

10 Reg. § 1.1371(g) (1959), as amended, T.D. 6667, 1963-2 CUM. BULL. 343.

11 Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965); Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964).

technique in most cases where Subchapter S is not going to be elected. This fact remains true since there will ordinarily be more to gain by trying than there is to lose.[12]

However, where Subchapter S status is desired, a new dimension is added. The very effectiveness of a Subchapter S election will depend upon the validity of the debt. Where, under the circumstances, it is important to have a Subchapter S election available, it will generally be inadvisable to thin the new corporation. This generalization is all the more valid in view of the additional fact that the usual tax advantages of proper thinning will, for the most part, be equally attainable by the Subchapter S election. Most significantly, the earnings will be freely withdrawable by the shareholders at no added tax cost. Little or no additional benefit will ordinarily be obtained by thinning, even if the obligations to the shareholders are upheld as true debt securities.

More difficulty is encountered with another judgment question raised by the second class of stock obstacle. Ordinarily, a Subchapter S corporation is well advised to distribute all of its current earnings to its shareholders at or shortly after the end of each year. If the earnings are retained by the corporation, there is the possible risk that the earnings might later be locked into the corporation despite the fact that the shareholders have personally included those earnings in their taxable income.[13] On the other hand, the corporation may need those earnings in its business. The ideal compromise between these conflicting considerations is for the corporation to distribute the earnings, followed by a loan-back by the shareholders to the corporation. This compromise is ideal, however, only if the loan-back is clearly a loan. If the purported loan is held to be, in fact, a second class of stock, not only will the earnings be locked in, but the entire Subchapter S election will be forfeited. Unfortunately, no single answer to this dilemma is adequate for all situations, and no generalization is likely to be entirely valid. Generally, however, counsel will be well advised to adopt the following approach. First, an attempt should be made in all cases to discourage the loan-back by the shareholders. Second, if it is absolutely necessary that the earnings be available for the business, *and* if the corporation has *always* been a Subchapter S corporation, counsel may have to re-

[12] See generally, CAVITCH, OHIO CORPORATION LAW WITH FEDERAL TAX ANALYSIS § 2.23 (1961).

[13] This risk may materialize if the corporation loses its Subchapter S status, or with respect to a particular shareholder's interest if his shares are transferred. CODE § 1375(d) (2) (A); Reg. §§ 1.1375-4(a), (e) (1959).

luctantly accept the decision to have the shareholders loan back the distribution to the corporation.[14] Lastly, if it is absolutely necessary that the earnings be available for the business, *and* if the corporation has a substantial amount of accumulated earnings and profits from years in which it was not a Subchapter S corporation, it will usually be preferable not to distribute the earnings in the first instance rather than to run the more frightening risk of losing the Subchapter S election by distributing the earnings and having the shareholders loan them back to the corporation.

D. *The Inadvertent Incurrence of the Ohio Personal Property Tax*

Stock owned by an Ohio resident is subject to the Ohio intangible tax.[15] The amount of the tax is ordinarily five per cent of the dividends actually paid during the year with respect to the stock.[16] This will ordinarily be true whether or not the corporation has elected under Subchapter S. However, if the taxpayer reports his personal property tax under the so-called "federal election" method, the five per cent rate generally applies to all income of the taxpayer subject to federal income tax.[17] In such event, the shareholder of the Subchapter S corporation will pay a personal property tax based upon his entire share of the corporation's ordinary income and capital gain, whether or not any part thereof has actually been distributed to him.[18]

E. *The Unavailability of Subchapter S Treatment if Prohibited Income Exceeds a Certain Amount*

A Subchapter S election will automatically terminate if in any year the corporation derives more than eighty per cent of its gross receipts from sources outside the United States or, more importantly, if it derives more than twenty per cent of its gross receipts from royalties, dividends, interest, stock and security gains, and rents.[19] It must be observed, in this respect, that gross *receipts*, not gross *in-*

[14] If the corporation has always been a Subchapter S corporation, it is likely to have little or no accumulated earnings and profits in the federal income tax sense. CODE § 1377(a). If so, the loss of Subchapter S status will not have as drastic a "locked-in" effect as would be the case if substantial earnings and profits existed.

[15] OHIO REV. CODE §§ 5709.02, 5711.01.

[16] OHIO REV. CODE § 5707.03(A).

[17] OHIO REV. CODE §§ 5701.10, 5711.10.

[18] Michael v. Bowers, 174 Ohio St. 169, 187 N.E.2d 890 (1963).

[19] CODE §§ 1372(e)(4), (5).

come, is the criterion. Counsel must be alert to situations where a Subchapter S corporation may inadvertently become disqualified by virtue of its investment-type receipts (including gains from appreciated securities) exceeding the twenty per cent standard.[20]

II. PARTNERSHIP V. CORPORATION: WHEN INCORPORATING MAY BE COSTLY

One of the most frequent questions encountered by the business advisor is whether a proposed or existing business venture should be incorporated. In making this determination, the advisor will have to weigh the relative importance of both tax and nontax factors.[21] One will almost always find that the nontax factors favor the corporation. Through the relatively easy step of incorporating, the business owners will obtain limited liability, will place management authority exclusively in the person or persons designated by a majority in interest, will obtain a business continuity not interrupted by the death of any owner, and will have ownership interests which can be made as easy or as difficult to transfer as the owners may wish. Also, from the nontax standpoint, there will be no significant, offsetting disadvantage. Furthermore, incorporating will frequently result in substantial tax savings. In many other cases, taxes will be a neutral, or almost neutral, factor. It is therefore not surprising that many advisors have concluded that the corporation is *the* way to conduct business and have refused to consider other alternatives.

In certain situations, however, incorporating a venture can be enormously expensive from the tax standpoint. Where this is so, there usually is a more acceptable alternative. An example may be helpful to illustrate this important point. Suppose that fifteen individuals invest equal amounts in a venture for the construction and operation of a motel. Each investor has 15,000 dollars of taxable income from other sources. It is anticipated that the venture

---

20 Any violation of the standard, no matter how insignificant in dollar amount, will terminate the election. No "de minimis" rule applies for this purpose. Temple N. Joyce, 42 T.C. 628 (1964).

In this connection, the Service has issued a number of helpful rulings clarifying the situations where rental-type receipts will not constitute "rent" for this purpose. Briefly and generally, payment for the use of real or personal property does not constitute rent if the corporation furnishes substantial services. Rev. Rul. 112, 1961-1 CUM. BULL. 399; Rev. Rul. 232, 1964-2 CUM. BULL. 334; Rev. Rul. 65-40, 1965 INT. REV. BULL. NO. 9, at 28; Rev. Rul. 65-83, 1965 INT. REV. BULL. NO. 13, at 8; Rev. Rul. 65-91, 1965 INT. REV. BULL. NO. 14, at 14.

21 See generally CAVITCH, *op. cit. supra* note 12, § 1.1.

will produce 150,000 dollars of income each year. Furthermore, assume that the participants in the venture are investing for maximum current income. On these assumptions, it is interesting to compare the annual income tax burden if the venture is incorporated with the corresponding burden if it is not incorporated. In the former situation, the corporation will pay an annual income tax of 65,500 dollars and will have 84,500 dollars of income remaining to distribute to its shareholders. This additional dividend income to the shareholders will result in additional income taxes to them in the aggregate amount of 20,600 dollars. Accordingly, if incorporated, the venture will result in total income tax liabilities (corporate and individual) equal to approximately 86,100 dollars. By contrast, if the venture is not incorporated, the total taxable income of 150,000 dollars will be taxed directly to the fifteen owners and will generate additional income taxes to them of 42,200 dollars. Under these facts, incorporating would result in an annual, recurring tax loss of 43,900 dollars on projected total earnings of 150,000 dollars.

A. *Subchapter S Election*

It may be contended, often with complete justification, that at the time the above investment was made, it was not known whether or not the venture would be a success. Suppose the investors had not incorporated and the venture had failed; what about personal liability on the mortgage? It might also be contended that, as partners, how can the fifteen owners be certain that one of them might not carelessly bind the partnership to unforeseen obligations? Surely, the risk of either of these catastrophes can, in many cases, rule out a general partnership as a possible form of business, regardless of the tax projection.

In these circumstances the ideal way of obtaining the important nontax benefits without the indicated tax loss is by incorporation and the subsequent election of Subchapter S status. But Subchapter S will not always be available in the very kind of situation where it is most needed. First of all, Subchapter S is not available if more than twenty per cent of the corporation's gross receipts is derived from rents.[22] Secondly, Subchapter S is not available, regardless of the source of income, if the corporation has more than ten shareholders. It is precisely in the situation where there are a relatively

---

22 Income derived from a motel operation will not ordinarily be considered rent for this purpose. See note 20 *supra*.

large number of shareholders that the distribution of current earnings is most likely to be required. In the above example, Subchapter S treatment is clearly unavailable since more than ten shareholders were involved.

B. *Limited Partnership*

Even where Subchapter S is unavailable, the choice of a business organization is not necessarily limited to that of a conventional corporation with its onerous double tax burden or a general partnership with its unlimited liability and mutual agency of partners. Frequently, the next best alternative is the limited partnership; unfortunately, business advisors sometimes pass over this alternative without adequate consideration.

Under the Ohio Limited Partnership Act,[23] it is possible to create a limited partnership which approximates the nontax virtues of a corporation in regard to limited liability,[24] centralized management,[25] and the other usual corporate attributes.[26] In most cases, where neither the conventional corporation nor the general partnership is a desirable alternative, the limited partnership will be a happy solution.

Where the limited partnership is used in order to avoid the double tax pattern incident to the conventional corporation, it will be imperative to make as certain as possible that the limited partnership will not be characterized as an association — that is, a corporation — for federal income tax purposes. Both the Internal Revenue Service and the courts take the position that where an unincorporated business venture has too many of the characteristics of a corporation, it will be treated as a corporation for tax purposes. Fortunately, for planning purposes, the government's position is set forth in substantial detail in the Kintner Regulations.[27] An examination of each of the criteria for testing whether a particular limited partnership will or will not be treated as a corporation for tax purposes is beyond the scope of this article. It must suffice, for the present purposes, to refer to the Kintner Regulations and to the assurance that

23 OHIO REV. CODE ch. 1781.

24 OHIO REV. CODE §§ 1781.01, .09(A).

25 OHIO REV. CODE §§ 1781.09, .10.

26 With respect to continuity of life, see OHIO REV. CODE § 1781.20. With respect to transferabiliy of ownership interest, see OHIO REV. CODE §§ 1781.02(A)(1)(j), .09(A)(5)-(6), .19(D).

27 Reg. §§ 301.7701-1 to -4 (1960), as amended, T.D. 6797, 1965-2 CUM. BULL. 39.

if the limited partnership agreement is drafted with care and an awareness of the criteria involved, the characterization as a corporation can be avoided.

The obvious lesson to be learned from the above discussion is that when doubt exists, a business venture should not incorporate. The venture can always be changed from a partnership to a corporation in a tax-free transaction.[28] But once the venture is incorporated, the move back to a partnership may be prohibitively expensive due to tax factors.

C. *Incorporation with Subsequent Liquidation*

Assume that the motel venture previously mentioned was incorporated and that one year later, after it has proven to be successful, the owners realize that a partnership operation would be far more economical. What courses of action are available to them?

If Subchapter S can be elected, this would normally be the ideal answer. But where there are more than ten shareholders, Subchapter S is unavailable. In such cases, corporate liquidation should be considered.

(1) Ordinary Corporate Liquidation.—Under the usual tax rule applicable to corporate liquidations, the shareholders will be taxed, usually at capital gain rates, to the extent that the fair market value of the motel operation exceeds the shareholders' original cost of their stock.[29] Thus, if the venture has proven successful, the usual tax rule presents the formidable risk that the Internal Revenue Service will assert a fair value for the operation greatly in excess of the original investment, with possibly disastrous tax consequences to the shareholders, particularly if the corporation is also deemed to be collapsible.[30]

(2) The 30-day Liquidation Rule.—Under this alternative, unrealized appreciation in the value of the corporate assets is not nearly as material to the tax consequences as in the case of an ordinary liquidation.[31] Rather, under this elective treatment, any gain realized by the shareholders on the liquidation is taxed as ordinary income to them but only to the extent of the corporation's earnings and

---

28 CODE § 351.
29 CODE § 331.
30 CODE § 341.
31 CODE § 333.

profits.[32] In certain cases, the 30-day liquidation tax treatment presents an available solution. But frequently the corporation and its shareholders may be faced with a dilemma. If the motel has not been in operation for a period of at least three years prior to the liquidation, the 30-day liquidation alternative may be foreclosed by virtue of the applicability of the collapsible corporation provisions.[33] If the venture is more than three years old, the corporation may have a substantial amount of accumulated earnings and profits. If so, those earnings and profits may be taxed as ordinary income to the shareholders on a 30-day liquidation elective treatment. It may, in brief, be simply impossible to liquidate the corporation without the certainty or substantial possibility of a heavy tax cost.

(3) *Depreciation Recapture Rules.*—The difficulties may indeed be compounded by the depreciation recapture rules which have been applicable to personal property since 1962 and to real property since 1964.[34] Under these rules, which are clearly applicable when a corporation distributes assets in kind to its shareholders on liquidation, a part or all of the depreciation deductions previously taken by the corporation may be added back to the corporation's taxable income for its final tax year.

III. CONCLUSION

Admittedly, a recitation of these tax dangers of liquidating the corporate venture resembles the old "parade of horrible possibilities." More often than not, however, in the context of our present discussion, they are more likely to be a "parade of horrible *probabilities*." The moral is clear: Where the tax cost of operating in corporate form is likely to be greater than operating in noncorporate form, but the nontax virtues of a corporation are significant, Subchapter S should be considered first. If that course of action is not available, the business advisor should consider the possibility of the limited partnership. A too-hasty use of the conventional corporate form of business organization may place a business venture in the frustrating position of being forced to remain incorporated, while the owners watch the tax dollars needlessly dribble away.

---

[32] In addition, if a particular shareholder receives cash or certain securities in a total amount which exceeds his ratable share of the corporation's earnings and profits, that excess may be taxed as capital gain.

[33] CODE § 333(a).

[34] CODE §§ 1245, 1250.