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Tax Problems of Close Corporations: A Survey

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# TAX PROBLEMS OF CLOSE CORPORATIONS: A SURVEY

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Tax Problems of Close Corporations: A Survey

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By far the majority of corporations in the United States are closely held. It is therefore no coincidence that our tax laws contain so many provisions or that the courts have developed principles having special application to the close corporation. A few of the statutory provisions afford special advantages to the close corporation and its owners. More frequently the legislation and judge-made law are designed to curb various practices of the close corporation and its owners which are regarded as unfair. These provisions and principles substantially increase the volume of our statutes, rules, regulations, and decisions. More significantly, they include some of the most complicated and difficult areas in our tax structure.

At the same time, it is the small and closely held corporation with which the general practitioner is primarily concerned in his day to day practice. The result is a curious and unfortunate anomaly — that the practitioner who can least afford the time and effort to become and keep familiar with tax matters is most frequently the very one who must advise and counsel the taxpayers who are most intimately affected by their complexities.

Despite this, there have been surprisingly few comprehensive surveys of tax law as it affects the close corporation for the guidance of the gen-

1. This article is based on the material contained in a series of lectures given at the Cleveland Regional Tax Institute, Saturday Session, September 20, 1958, sponsored by the Cleveland Bar Association.
2. All of the Cleveland Bar.
3. Of the 842,125 corporations in the United States in 1955 only 55,574 had total assets of $1,000,000 or more and only 14,701 had total assets of $5,000,000 or more. U.S. Treas. Dept., Internal Revenue Service, Statistics of Income—1955, 7-8. At about the same time only 2,573 corporations had shares listed on a stock exchange. Securities and Exchange Commission, 23rd Annual Report, 227. It appears likely that shares of fewer than 50,000 corporations are traded over-the-counter. See Friend, Hoffman and Wynn, The Over The Counter Securities Market, 46, 53, (1958).
eral practitioner. This then is what we regard as the justification for this effort. It will serve its intended purpose if it suggests the general tax considerations to be observed in the conception and birth, the various stages of life and in the death and burial of the close corporation. In addition, it is hoped that it will suggest possible approaches and practical solutions to some of the problems. However, it should be recognized that our principal objective is the former rather than the latter, and that this article is intended to be but a starting point, and not a substitute, for further research.\(^5\)

I. Pre-Incorporation Planning

A. Deciding Whether To Incorporate

1. Considerations Apart from Federal Income Tax

Except in those few instances when local law requires the unincorporated form for certain classes of activity, proprietors have a free choice of carrying on their activities in corporate form. The distinct advantages of the corporate form in assuring continuity of the enterprise, centralized management, limited liability of the proprietors, and easing the division and transfer of proprietary interests will generally be found to outweigh the non-tax and state tax disadvantages.\(^6\) Furthermore, the corporate structure offers substantial advantages from the viewpoint of gift and death tax planning, and there is considerably greater flexibility in transferring interests and dividing and preserving the division of property within the family.\(^7\) Also, incorporation provides a real possibility for minimizing valuation problems\(^8\) where, otherwise, determining "fair mar-

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5. References to sections of the Internal Revenue Code of 1954 will generally be made by section (§) number only. References to "Reg." are to the Income Tax Regulations.

6. E.g., the additional accounting, record keeping and reporting requirements under local law and the necessity of qualifying the corporation to do business in states other than that of incorporation. The initial and annual state taxes and costs as well as the possibility of multiple and overlapping state taxation are usually not of consequence.

7. For example, the controlling equity can be thinned by debt or senior stock and transferred *inter vivos* with a minimum of gift tax payable, or the shares can be readily given to several donees over a period of years in order to take full advantage of the $3,000 (or $6,000) annual gift tax exclusions under § 2503(b) and § 2513. Beneficial ownership of shares can readily be transferred to minors through custodianship (see OHIO REV. CODE § 1339.19 et seq.) or to minors or others through *inter vivos* or testamentary trusts. Such transfers can be accomplished without dilution of control when the capital consists of voting and non-voting shares, and gifts are made of the latter.

8. For example, sale of some stock to outsiders or the existence of a formula price in a properly drawn buy-sell agreement may fix the value. See infra, p. 88. Sometimes the valuation at death may be frozen by retention of preferred shares with a fixed value after *inter vivos* disposition of the common equity.
ket value" without any existing market, fair or otherwise, can be fraught with difficulties. Therefore, in most cases, in the absence of federal income tax, incorporation would be almost invariably indicated where local law permits a free choice.

2. **Federal Income Tax Considerations**

Incorporation results in the creation of a new taxpayer separate and distinct from its proprietors. This gives rise to certain advantages and disadvantages under the federal income tax, the relative importance of which varies according to the circumstances of the particular case.

*Comparative rate structure and tax base.* In contrast to the steeply graduated rates on other taxpayers, the corporate rate is 30% on the first $25,000 of ordinary taxable income and 52% on the excess. Long term capital gain of corporations is taxed at a flat 25% in a fashion similar to that of individuals. Generally taxable income of the corporation is computed in the same manner as that of unincorporated businesses. One exception, however, is that in the case of the corporation capital losses are not deductible from ordinary income to any extent. Another exception is that only 15% of dividends received from domestic corporations is includible in taxable income of the corporation. It will be readily perceived that these differences in rate and tax base\(^9\) may be either advantages or disadvantages as compared to the individuals carrying on the business as a sole proprietorship or partnership, depending upon the particular circumstances.

*Change in character of income.* Sometimes, whether an asset is one which may be given long term capital gain treatment, taxable at the ceiling rate of 25%, depends upon the identity of the owner or the character of the owner's activities. For example, property not held for sale to customers in the ordinary course of an individual's trade or business almost certainly becomes stock in trade in the hands of a corporation whose stated purpose is to merchandize such property. More importantly, income loses its distinctive character upon passing through the hands of the corporate taxpayer. Thus, dividends received by the shareholders are taxed as ordinary income even though they represent corporate earnings derived from long term capital gains, tax exempt municipal bond interest or life insurance proceeds received by the corporation.\(^10\) This latter is frequently a disadvantage of using the corporate form for ownership of such assets.

*Double taxation.* Income earned by a sole proprietorship or a part-

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9. See §§ 11, 1201(a), 1211(a), 243, 246.
10. Reg. § 1.312-6(b) (1955). See *infra*, p. 25, for discussion of retaining rather than transferring such assets to the corporation.
partnership is taxed but once in the hands of the proprietor. In contrast, income earned by a corporation is taxed twice — once at the corporate level as earned and again at the shareholder level when distributed, or realized as capital gain. The resultant double taxation is partially mitigated by the $50 exclusion and the 4% dividends received credit allowed to non-corporate shareholders. In addition, the double taxation of corporate earnings may be avoided entirely to the extent that compensation, rents, royalties, interest and other items deductible to the corporation are paid to the shareholders. However, it is an extremely rare case where the double taxation of corporate earnings can be completely eliminated in this fashion. Therefore, in deciding whether to incorporate or to operate the business in non-corporate form, double taxation should be frankly recognized as a disadvantage to be weighed against the other tax and non-tax advantages.

**Special corporate taxes.** The statute is not only designed to tax corporate earnings twice, but also contains provisions designed to coerce corporations into paying dividends so as to assure that double taxation. Thus, closely held corporations, which derive their principal income from certain designated sources are automatically subjected to the personal holding company surtax at near confiscatory rates on earnings retained. While the personal holding company surtax operates in only a limited number of cases, there is the accumulated earnings tax which applies generally in all other cases where the corporation is “formed or availed of” to avoid income tax on shareholders by retaining its earnings. The prescribed purpose of avoiding personal income tax is presumed to exist if the corporation permits its earnings to accumulate beyond the “reasonable needs” of the business or is merely a holding company. The existence of these special corporate surtaxes should be recognized as a disadvantage to incorporating and a distinct problem which the corporation must eventually face if it prospers.

**Election as to taxable status.** It is now possible that, in certain cases, the close corporation and its owners may be relieved of the double tax disadvantage and, to a limited extent, of the disadvantage that income loses its special character upon passing through corporate hands. Section

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11. §§ 34 and 116. *Cf.* § 247 (deduction allowed to public utilities for dividends paid on their preferred stock.)

12. § 541 *et seq.* imposes on the corporation a tax of 75% on the first $2,000 and 85% on the balance of retained earnings (excluding long-term capital gains). See *infra*, p. 72.

13. § 531 *et seq.* imposes on the corporation a tax of 27 1/2% on the first $100,000 and 38 1/2% on the balance of retained earnings after a $60,000 credit. For taxable years beginning after December 31, 1957, this credit is $100,000. Small Business Tax Revision Act of 1958, § 205. See *infra*, p. 73.
64 of the Technical Amendments Act of 1958 enacts a series of complex provisions which are designed to offer such relief. These provisions permit the shareholders of a "small business corporation" to exempt the corporation from income tax by electing to include the corporation's current taxable income in their own personal returns whether or not actually received by them. In general, this income is treated as ordinary dividends received without regard to any special character which it may have had to the corporation. Only in the case of long term capital gains will such income retain its special character in the hands of the shareholder. In similar fashion, the shareholder may deduct on his personal return his pro rata portion of any net operating loss of the corporation if the election is made. The undistributed corporate earnings so taxed to the shareholder increase the basis of the shares and corporate losses so deducted by him decrease the basis of the shares or corporate indebtedness owned by him.

It is, of course, much too soon to predict with any degree of certainty how generally these new provisions will be used. The class of corporations permitted the election is narrow. The shareholder's election must be unanimous and must be made blindly. Once made, it is binding for subsequent years until terminated. Apparently, however, such termination may be accomplished at will, but the corporation thereafter is in-

15. § 1371(a) defines this term to include only (a) domestic corporations (b) which have only one class of shares outstanding, (c) which have no more than 10 shareholders, (d) all of whom are individuals or estates and (e) none of whom are non-resident aliens. There are no ownership attribution rules applicable here. The ten shareholders test, therefore, means actual, not constructive, ownership of shares. It excludes corporations which are eligible to file consolidated returns with another corporation, i.e. parent corporations owning 80% or more of another corporation. See § 1504(a). Also it apparently excludes a corporation if any of the stock is owned by a trust, charitable organization, etc., and probably excludes corporations with thin capital which may be regarded as in substance preferred shares. §§ 1372(e) (4) and (5) in effect exclude a corporation having more than 80% of its "gross receipts" from foreign sources or having more than 20% of its "gross receipts" from rents and certain other personal holding company income sources.
16. But without the $50 exclusion or 4% credit for dividends received. § 1375(b).
17. § 1375(a).
18. § 1374. Such deduction is allowed only until the shareholder's basis of shares and corporate indebtedness owned by him is absorbed thereby. § 1374(c) (2).
19. § 1376.
20. Under § 1372(c) (1), the election must be made in the first month of the corporation's taxable year or in the last month of the preceding year.
21. § 1372(d). But cf. election for certain years which overlap the date of enactment. § 1372(c) (2).
22. Under § 1372(e), termination occurs if a new shareholder comes in and fails to make the election, if there is unanimous action by the shareholders to revoke the election within the first month of the corporation's taxable year, or if the corporation
eligible to make another such election until five years have intervened.\textsuperscript{23} It is also important to observe that there are a number of uncertainties in the use of these provisions which only time and experience will answer. For example, there is risk that the Commissioner may allocate income not in accordance with share ownership but to reflect his idea of the value of services rendered by each shareholder where these include two or more members of a family.\textsuperscript{24} The statute is silent as to the effect on shareholder's basis where that authority is exercised.\textsuperscript{25} It appears to us that, in any event, these special provisions may be elected to advantage where the corporation is expected to generate losses which the shareholders can use to advantage currently or by carryback or where substantially all of the corporation's earnings are expected to be distributed currently\textsuperscript{26} particularly at any time during its taxable year ceases to meet the requirements of "small business corporation." See note 15, \textit{supra}. Under the latter, it would appear that the election may be terminated if on the last day of the corporation's taxable year the number of shareholders is increased to 11 or more by gifts or sales of a few shares, or a few shares are given to charity or put in trust, or if a second class of shares is created (e.g. by a stock dividend of non-voting common on voting common shares.) In view of the facility with which the election can thus be terminated late in the year, it seems senseless to limit revocation by shareholder action to the first month of the year.

\textsuperscript{23} § 1372(f).

\textsuperscript{24} Under § 1375(c), \textit{e.g.} where one shareholder-employee is regarded as inadequately compensated for his services and the other does not work for the corporation or is adequately compensated for his services. Thus we may now be treated to the spectacle of the Commissioner's contending that executive compensation is less than a "reasonable allowance." Cf. § 162(a)(1). He would gain nothing by such a contention where the two shareholders are husband and wife filing a joint return but might gain much where they are father and child. See § 704(e)(3), the family partnership section, which is incorporated here by reference in § 1375(c).

\textsuperscript{25} Other unanswered problems stem from whether the separate corporate entity will be fully respected for tax purposes despite the election. While in a loose sense, these sections permit the shareholders to elect to be taxed as a partnership, still they proceed on the premise that the separate entity exists and must be respected. Thus, the corporation and its shareholders may have different taxable years despite the election even though partners and their partnership may not. See § 706(b). It also seems clear that contributions to qualified pension and profit sharing plans for the benefit of shareholder-employees are deductible by the corporation notwithstanding an election under these provisions and notwithstanding the fact that no such plans are possible for partners. See \textit{e.g.} §§ 1373(d) and 1374(c)(1) which require that taxable income and net operating loss of the corporation for this purpose be computed without the special deductions for partially tax exempt interest, dividends received and dividends paid (§§ 241 through 247) but with the benefit of the deduction for amortized organizational expenses (§ 248). But if, as indicated, this is the basic philosophy of new Subchapter \textit{S}, then § 1375(c) discussed in note 24, \textit{supra}, appears somewhat out of line.

\textsuperscript{26} \textit{E.g.}, where to retain the earnings in the corporation would clearly subject them to accumulated earnings tax under § 531 and where the shareholders' brackets are low enough to make taxation to them personally preferable to taxation at the corporate rates.
particularly where it is expected that the corporation's earnings for the particular year will consist substantially of long term capital gains.\textsuperscript{27}

Other factors. The foregoing are merely some of the principal income tax considerations to be weighed in the particular case. In a real sense, everything discussed hereinafter are also factors which should be taken into account in the proper case. However, it is believed that in most situations the advantages of incorporating will be found to outweigh the disadvantages. The question then becomes how, where and when to incorporate so as to avoid certain possible traps and to minimize the federal tax disadvantages to the extent reasonably possible.

B. DECIDING WHETHER TO HAVE MORE THAN ONE ENTERPRISE

Having decided to incorporate, consideration should be given to the possibility of operating through several entities. This can be accomplished in the proper case simply by retaining certain of the business assets in the shareholders' names or in a partnership of the shareholders with a lease or license of the assets to the corporation, if necessary. In other cases it can be done by retaining certain functions or operations (e.g. selling) and incorporating others (e.g. manufacturing). In the alternative, it may be accomplished by creating more than one corporation, again dividing the enterprise by transferring part of the business assets or separate functions or operations to each.

Dividing the business in this fashion has a number of advantages. Operating part of the enterprise as a sole proprietorship or partnership avoids \textit{pro tanto} the double taxation which would result if so much of the profits were otherwise earned by the corporation. Greater flexibility for future planning (e.g. withdrawal of assets, sales, liquidations, mergers, etc.) is also attained. Furthermore, the income being taxed to more than one taxpayer results in a reduction in the tax brackets at which it is taxed. This is true even where the enterprise is split between two or more corporations since each of them is entitled to a $25,000 surtax exemption and a $100,000 credit against the accumulated earnings surtax. Here, as in so many areas, it is possible to do at the outset what is difficult or impossible to do later. Thus, division of the enterprise at the

\textsuperscript{27} But the election under Subchapter S is generally no substitute for use of §337(a) where the assets are to be sold in course of liquidation. Under the latter provision, corporate tax may also be eliminated with only long term capital gain consequences to the shareholders on the entire amount distributed to them. \textit{Cf.} the possibility of ordinary income consequences to shareholders under Subchapter S to the extent profit is derived from sale of inventory etc. \textit{Quaere} whether an election under Subchapter S may not be used to avoid the consequences of §341, relating to collapsible corporations, when §337(a) is not available.
time of incorporation offers advantages which may be difficult to obtain upon a later division of the enterprise.\textsuperscript{28}

It should be recognized that there are some disadvantages in setting up the enterprise in multiple entities. The principal one is the possibility that one of the entities may have losses while the other has profits. Since each is a separate taxpayer, the one's losses may not be offset against the other's profits and may give no benefit either currently or eventually through carryback or carryforward against its own profits.\textsuperscript{29} Moreover, the use of multiple entities involves arrangements between them which are subject to close scrutiny and possible reallocation by the Internal Revenue Service and the courts. Accordingly, it is important that a sound non-tax basis exist for division of the enterprise in this fashion and that the arrangements between them be the equivalent of arms' length.\textsuperscript{30} If, upon meeting these requirements, each of the entities will be self-sustaining (or if loss will fall where it can be absorbed against other income) there is every reason to set up the enterprise in multiple entities.

C. \textbf{DECIDING WHETHER TO HAVE PARENT-SUBSIDIARY OR SISTER CORPORATIONS}

If it is decided to divide the enterprise using two or more corporations, it then becomes necessary to consider whether these should be sister corporations under common control or should be parent and subsidiary. There are advantages in either case.

Use of sister corporations avoids the intercorporate dividend tax assessed in the parent-subsidiary set-up, a tax which though relatively small represents treble taxation of corporate earnings. More significant is the fact that where the business of one corporation is truly a separate function or operation of the enterprise, it may later be sold or liquidated with less tax than if it were the parent or a subsidiary.

On the other hand, use of the parent-subsidiary set-up permits the use of consolidated returns if necessary to absorb the losses of one against

\textsuperscript{28} See §§ 269 and 1551, and discussion \textit{infra}.

\textsuperscript{29} Properly timing the incorporation or election under Subchapter S may protect against this result for 'starting' losses. See discussion, \textit{infra}, p. 18, \textit{supra}, p. 12.

\textsuperscript{30} See § 482. Generally this should pose little or no problem since division of assets, functions or operations will necessarily involve the insulation of one against the business risks of the others. Chester E. Spangler, 18 T.C. 976 (1952), acq., 1953-1 \textit{CUM. BULL. 6}; Riddlesbarger v. Commissioner, 200 F.2d 165 (7th Cir. 1952).
the profits of the other.\textsuperscript{31} Consolidated returns are not permitted of sister corporations. Similarly, the reasonable needs of the subsidiary corporation's business may justify the retention of earnings by its parent; but the needs of one sister corporation's business do not justify accumulation by another sister even though their two businesses are closely related.\textsuperscript{32}

Sometimes, non-tax considerations will determine whether the sister corporation or parent-subsidiary set-up should be used.\textsuperscript{33} However, when there is a free choice, use of sister corporations will generally be found more desirable because of the greater flexibility thereby possible. Indeed, if one segment of the business is more risky than the other, or one more certain of growth, the sister corporation set-up makes possible a variation in or complete diversity of interests in the two as will best meet the family situation of the shareholders. If at a later date tax or non-tax considerations make advisable a shift to the parent-subsidiary set-up, generally this can then be accomplished without undue tax exposure to the corporations or to the shareholders.

D. CHOOSING THE RIGHT STATE OF INCORPORATION

Generally, the choice of state in which to incorporate is dictated by non-tax or state tax considerations. In some cases, however, choice of the state of incorporation has federal tax overtones. For example, if the corporation is to engage in a business which involves heavy depreciation or depletion charges, it may be important to incorporate in a state which permits dividends to be paid from depreciation and depletion reserves, since such dividends may be received tax free until they exceed the shareholder's adjusted basis of his shares and thereafter as capital gain.\textsuperscript{34}

\textsuperscript{31} § 1501 et seq. But this entails the disadvantages of 2\% additional tax for using the privilege and the fact that once a consolidated return is filed, the taxpayers may be bound to file consolidated returns for an uncertain number of future years when it may be disadvantageous to do so.

\textsuperscript{32} Compare proposed Reg. § 537-3 (b) (1958); SEN. REP. No. 1622, 83rd Cong., 2d Sess. 70 (1954), with Larchis Theatres v. Commissioner, 214 F.2d 834 (1st Cir. 1954); Proposed Reg. § 537-2 (c) (3) (1958).

\textsuperscript{33} E.g., where the enterprise is financed by outside debt, the lending institution may well prefer the parent-subsidiary set-up.

\textsuperscript{34} § 301(c) (2) and (3); e.g., MONTANA REV. CODE ANN. § 15-407 (1947). See e.g., OHIO REV. CODE § 1701.35. Differences in state laws on statutory mergers may also be important. Similarly, if an arrangement for corporate buy-out of shares is contemplated, care should be taken that the state of incorporation is chosen which permits such buy-out on the most liberal basis.
E. CHOOSING THE RIGHT TIME TO INCORPORATE

By properly timing the incorporation, particularly of a new business, potential savings of federal income tax are possible. 35 When the business has been operated in unincorporated form at a loss, consideration should be given to deferring incorporation until its losses have been absorbed by the proprietors through carryforward. 36 In contrast to the transfer of a business from one corporation to another, there is no provision for use by a corporation of losses sustained by its unincorporated predecessor.

Even where the business has no prior history, consideration should be given to deferring incorporation until the business is well established, if, for example, starting losses are expected. Here it may be found that such losses may be absorbed to advantage currently or by carryback by the proprietors continuing the operation for a time in a non-corporate form. However, the same result to the owners may now be possible with respect to current losses by making an election under Subchapter S. 37 If a Subchapter S election is not made, the new corporation will have at most a possible future benefit of such losses.

In weighing these factors, it should be kept in mind that the existence as well as amount of losses are frequently matters within the taxpayer's control. For example, many businesses experience seasonal fluctuations either in volume or in net profit. Nothing requires the taxpayer to incorporate the business, nor to incorporate it at a particular time. He is free to operate in non-corporate form through the loss portion of the year using the loss against his other income and to incorporate the business on the eve of the profit portion of the year. 38 Similarly, the taxpayer can minimize income or maximize loss upon incorporation by proper choice and use of accounting methods and procedures. A cash method taxpayer, for example, should pay deductible items prior to incorporation in order to obtain the benefit of the deduction personally. If the corporation assumes the obligation for these, it is possible that neither the individual nor the corporation will be allowed the deduction. 39 Conversely,

35. Judicious timing may also yield substantial state tax savings. See e.g., OHIO REV. CODE § 5733.01, which imposes a franchise tax for doing business on or after January 1, and OHIO REV. CODE § 4503.10, which permits transfer of motor vehicle titles between March 1 and April 1 without double tax.


37. See discussion, supra, p. 12.

38. This is merely the reverse of the fact situation involved in Diamond A Cattle Co. v. Commissioner, 233 F.2d 739 (10th Cir. 1956).

39. The cash basis individual would have no deduction because the corporation, and not he paid it. The corporation would have no deduction because it was the individual's not its expense. Quaere whether the individual would be regarded as having constructively paid the item.
the cash method taxpayer should retain rather than transfer accrued income items to the corporation. 40

F. CHOOSING THE RIGHT METHOD OF INCORPORATING

When cash is the only asset to be transferred to the new corporation, it makes no difference whether the incorporation is of the taxable or tax-free variety. Nor does it make a difference in those rare instances where each of the assets to be transferred to the new corporation has a fair market value precisely equal to its adjusted basis in the hands of the incorporators. In all other cases, there is a basic choice whether the property should be transferred to the corporation in a non-taxable transaction or in a taxable transaction. The choice is available as to each asset and, therefore, a combination of both methods is possible upon incorporation. Regardless of which choice is made the corporation will not realize income upon the receipt of the property. The corporation is affected only in that its basis and holding period are usually dependent upon whether or not the transaction is taxable to its transferors. 41 It is the transferors of the property who face the immediate tax problem.

1. Tax-free Transfers to the Corporation

Generally speaking, it will be found advantageous to mould the transaction so that neither gain nor loss will be recognized to the transferors. This can be simply accomplished by one or more persons transferring property to the newly formed corporation solely for stock or securities in the corporation, and making sure that the transferors are in 80% control of the corporation immediately after the transaction. 42 Only a few points need to be observed. First, property must be transferred; services are expressly excluded. However, the several contributions of property can be equalized with transfers of cash. Secondly, the stock issued by the corporation may be common or preferred, voting or non-voting, or a combination. There is no requirement that, where there are several transferors, each must share in every class so issued. Thirdly, where evidences of debt are also issued, they must be "securities" — i.e.,

40. The income might be taxed to the individual under Helvering v. Horst, 311 U.S. 112 (1940), even though actually received by the corporation. However, it otherwise would go untaxed where, for example, the corporation elects to use the accrual method. The proper method may be for the corporation to accrue the income in its first return.

41. §§ 362(a) and 1223(2) require the corporation to use the basis and holding period of the transferor for property received in a transaction non-taxable to the transferor.

42. § 351(a).
long term indebtedness, though not necessarily secured debt.\footnote{To be safe, the debt should have not less than a five year maturity. Compare Pan American Trust Company, 4CCH Tax Ct. Mem. 555 (1945), with Commissioner v. Sisto Financial Corp., 139 F.2d 253 (2d Cir 1943). It may be risky for some to receive only securities in view of the requirement of § 351 (a) that "such person or persons" be in control and the fact that § 368 (c) defines control solely in terms of stock ownership.} There is no requirement that each must receive stock and securities in the same proportions. Fourthly, there is no requirement that, where two or more transfer property, they must receive stock and securities valued in proportion to their respective contributions. However, where there is a disproportion, there may be in substance a gift or payment of compensation to the ones benefited by the disproportion. Fifthly, the provision that the transferors be in control "immediately after" requires caution in transferring shares by gift or sale shortly after incorporation. If enough is transferred to break the 80 per cent control requirement, the step transaction principal may be applied to make the transaction taxable.\footnote{Pickard v. Commissioner, 113 F.2d 488 (2d Cir. 1940); May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953).} Finally, there is one matter which is not pointed out in the statute, but which should be observed. There is a principle that where appreciated property is transferred in satisfaction of a dollar obligation, the transferor may realize gain. Where property is to be transferred to the corporation in kind, it may be advisable for the stock subscription so to specify.\footnote{Cf. Irving R. Lewis, 19 T.C. 887 (1953).}

Sometimes the transfer to the corporation can be accomplished tax free by a shareholder's simply contributing property to capital of the corporation without the issuance of stock or securities. This method will be found more useful after the corporation has been in existence for some time than at its inception. Indeed, its use at the time of incorporation as a substitute for the method above discussed involves basically the same problems as in the stock or securities transfer.\footnote{Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Commissioner v. Patino, 186 F.2d 962 (4th Cir. 1950). However, this may be only an abundance of caution. See Rev. Rul. 55-410, 1955-1 CUM. BULL. 297.} If the contribution is disproportionate to common share ownership, gift or compensation to the other shareholders benefited may be the result as above. Therefore, of the two methods for tax-free transfer of assets to the corporation, the familiar transfer for stock or securities appears the preferable one upon original incorporation.

Extreme caution should be observed where encumbered assets are transferred to the corporation in the hope of avoiding recognition of gain or loss to the transferors. While liabilities assumed or subject to which
the property is transferred are generally disregarded, they may be considered as the equivalent of money in two situations. One is where the arrangement is motivated principally by an income tax avoidance purpose or by other than a bona fide business purpose. The burden of proof by a clear preponderance of the evidence is upon the taxpayer in such cases. Therefore, beware of indebtedness incurred other than in the ordinary course of business on the eve of incorporation. The other danger which must be observed is where the indebtedness involved exceeds the adjusted basis of all the assets transferred by that person. In such a case, the excess is treated as money received on the exchange regardless of motive. The encumbrance may exceed the basis of the encumbered property so long as it does not exceed the total basis of all the property transferred by that particular transferor. It should be emphasized that the amount of the indebtedness is not compared with the value of the assets but rather with the adjusted basis of the assets. This then is a matter to be examined with care on every incorporation, but particularly when the asset basis may be questionable, a situation which all too frequently exists.

2. Taxable Transfers to the Corporation

While it is generally advisable to mould the incorporation so as to be non-taxable to the transferors, there are occasions when the converse may be desirable. First, when the property is worth less than its adjusted basis in the hands of the transferor, it may be advisable to generate a loss on the transfer even though this will result in a step-down in basis to the corporation. Where the property is non-depreciable (e.g., land which the corporation is expected to hold indefinitely), the corporation's basis is not of particular concern. Secondly, where the property is worth substantially more than its basis to the transferor, it may be advisable to generate a gain to the transferor in order to step-up the basis to the corporation. This may be attractive where the corporation's basis for purposes of depreciation can be increased at the cost of a capital gain to the transferor, or where property which is a capital asset in the hands of the transferor will become inventory in the hands of the corporation. It is also sometimes desirable in other cases where for example the transferor has capital gains against which to absorb capital losses, or ordinary losses against which he can absorb ordinary profits so generated.

Taxable transactions may take the form of a sale to the corporation

47. § 357.
48. But see § 1239, discussed infra at p. 23. See also § 179, enacted by Small Business Tax Revision Act of 1958, § 204.
for cash, a sale for short term notes, a combination of these, or a sale on contract providing for future payments. The latter methods have an additional advantage when the transferor has a taxable gain. If properly planned, the sale on credit to the corporation permits the transferor to elect the installment method and thereby to defer his gain to the time the payments of purchase price are actually received. This method is available for any sale of real property and any casual sale of personal property, other than inventory, for more than $1,000, so long as the payments received in the year of sale are 30 per cent or less of the selling price. Sale to the corporation on credit also accomplishes the generally desirable objective of thinning the corporation's capital. Thus, it may, if not properly handled, result in the debt being characterized as equity capital.

In all cases, the sale price must be fair or the transaction will be subject to possible readjustment by the Internal Revenue Service and the courts. In addition there are the following special statutory provisions which place some distinct limitations on these advantages of using a taxable transfer to the corporation.

**Loss transactions:** Where the seller owns, directly or indirectly, more than 50 per cent of the stock of the corporation, the seller's loss deduction is disallowed. This result obtains even though the price is right and regardless of good faith, business purpose or any other factor. Disallowance is automatic. However, it should be emphasized that the statute applies only if the seller owns directly or indirectly more than 50 per cent

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49. Care should be taken to avoid any appearance of the corporation's merely being a conduit for the seller's own cash, e.g., where there is but a single shareholder who puts cash into the corporation for stock and immediately withdraws all or part of the cash for the property. The step transaction principle might well be applied to treat this as in effect a tax free incorporation under § 351.


51. § 453. But the corporation's basis steps up immediately. As an alternative to the installment method, a cash basis taxpayer may not be required to report as cash or other property received non-negotiable promises by the seller to make future payments. In this event, no gain would be reported until actual cash payments exceeded the basis. Curtis R. Andrews, 23 T. C. 1026 (1955); Estate of Coid Hurlburt, 25 T. C. 1286 (1956), non-acq., 1956-2 CUM. BULL. 10, and cases cited. This alternative is likely to involve controversy with the Commissioner. Cf. Rev. Rul. 58-402, 1958 INT. REV. BULL. No. 33 at 8.


53. § 482 operates where actual control exists between the parties even though there is less than 51% legal control. See Reg. 118, § 39.45-1(a)(3).

54. §267.
in value of the corporation's stock. It does not operate when, for example, the stock is owned 50-50 by parties unrelated within the ownership attribution rules. But if the statute applies, not only does the seller obtain no deduction; he is unable to add the disallowed loss to the basis for his stock.

Where the statute applies, the result to the corporation is equally drastic. Even though the seller's loss is disallowed, the basis to the corporation, e.g. for depreciation, etc., is still its cost of the property. In contrast to the corporation's basis after a non-taxable transfer, the loss disallowed to the transferor is not reflected in the corporation's taxes except, unless and until the corporation sells or exchanges the property, and then only if it sells or exchanges the property at a gain.

Thus, while there are, in the proper case, important benefits to be obtained in the incorporator's selling assets to the corporation at a loss, the taxpayer must be very sure that the loss is allowable. Otherwise, both the shareholder and the corporation would be much ahead by transferring the property to the corporation in a non-taxable transaction.

**Gain transactions:** There are certain areas where Congress has dealt with the advantages of taxable transfers to the corporation at a gain. One of these is the sale of property which in the hands of the corporation is depreciable. The statute converts into ordinary income any gain upon sale or exchange of such property by an individual to a corporation more than 80 per cent owned by him, his spouse, minor children and minor grandchildren. Accordingly, this provision has a rather limited application. Where it does not apply, it is still possible to step-up the depreciable basis to the corporation at only capital gain cost to the selling shareholder.

55. § 267. Since the statute requires more than 50% in value of the outstanding stock, ownership of preferred shares by an unrelated party may put the owner of all or a majority of the common outside the statute.

56. § 1012.

57. § 267(d) provides that the corporation's gain shall be recognized only to the extent that it exceeds so much of the loss disallowed to the transferor "as is properly allocable" to the property sold. If the property is depreciable, presumably the Internal Revenue Service will contend that the disallowed loss must be reduced by a reconstructed depreciation.

58. § 1239, as amended by Technical Amendments Act of 1958, § 56. Here again the test is related to the value of the outstanding stock. See comments at note 55 supra. In contrast to other areas, there are here no applicable ownership attribution rules.

59. In should be kept in mind that an emergency facility which is being amortized under §§ 168 and 169 may also be an asset "of a character which is subject to the allowance for depreciation" within § 1239. Conversely, even if § 1239 does not apply, gain on sale of the emergency facility will be taxed in part as ordinary income under § 1238.
The other area dealt with is that of patents. Here the statute\textsuperscript{60} assures to a "holder," as defined, long term capital gain treatment upon sale or exclusive license of patents even though not a capital asset, even though held for six months or less, and even though the consideration is measured as if it were a royalty. The benefit of this provision is denied where the holder disposes of the patent to a corporation 25 per cent or more owned directly or indirectly by him.\textsuperscript{61} However, this special provision applies only to a "holder," which is defined to include only the creator of the invention and individuals (other than his employer or related persons) who purchased an interest in the invention from the inventor prior to its reduction to practice. Again, therefore, the statutory provision has a fairly limited application. More significantly, this provision is not exclusive but leaves to the other provisions of the law the tax consequence of transactions which are not within its scope. Thus, a transfer by a person who is not within the limited definition of "holder" or a transfer by a holder to a controlled corporation\textsuperscript{62} may still receive long term capital gain treatment if there is in fact a taxable sale or exchange of a patent which in the hands of the seller is a capital asset or property used in his business held for more than six months, and if Section 1239, discussed immediately above, is inapplicable.\textsuperscript{63} Furthermore, since a person who acquires the patent or an interest therein by gift is never a "holder," sale by such a person to a corporation is not affected by Section 1235(d) in any event.\textsuperscript{64} And, if the purchase price is measured like a royalty, it may be deducted by the corporation as the equivalent of depreciation.\textsuperscript{65}

The possibility of stepping up the corporation's depreciable basis assumes additional importance under new Section 179.\textsuperscript{66} That section permits the taxpayer, at its election, to deduct in the first year of its

\textsuperscript{60} § 1235.
\textsuperscript{61} § 1235(d), as amended by Technical Amendments Act of 1958, § 54.
\textsuperscript{62} Reg. § 1.1235-1(b). Leonard Coplan, 28 T. C. 1189 (1957), acq., 1958 INT. REV. BULL. No. 29 at 6. But cf. SEN. REP. NO. 1622, 83rd Cong., 2d Sess. 441 (1954), which states the intention "that, if the mode of payment is as described... the sale of a patent by any 'holder' must qualify under the section in order for such 'holder' to obtain capital gain treatment."
\textsuperscript{63} Associate Patentees, Inc., 4 T. C. 979 (1945), acq., 1946-1 CUM. BULL. 1. Note that the Internal Revenue Service now agrees that there may be a sale or exchange even where the consideration is measured by sales, profits or units over a period generally coextensive with the life of the patent. Rev. Rul. 58-353, 1958 INT. REV. BULL. No. 29 at 15.
\textsuperscript{65} Effective for taxable years ending after June 30, 1958, under Small Business Tax Revision Act of 1958, § 204(a).
ownership\textsuperscript{67} depreciation equal to $2,000 or 20\% of cost, whichever is the lesser, on tangible personal property then having a remaining useful life of six years or more, whether or not the property is new. The benefit of this section is not available where the property is acquired in a non-taxable transaction nor if acquired from a person who directly or indirectly owns more than 50\% in value of the corporation’s stock.\textsuperscript{68} Because the ownership rules for this purpose are different from those applicable in determining whether the seller has capital gain,\textsuperscript{69} this section may benefit the corporation even though the seller receives capital gain treatment and, conversely, the corporation may be denied this special depreciation even though the seller is denied capital gains treatment. Here again each case must receive special study in light of its particular circumstances.

\textit{Stock transactions:} In certain instances, the statute provides that the proceeds of sale of stock are to be taxed as dividend income. These provisions operate regardless of whether there is a gain or a loss on the sale. Accordingly, careful study must be accorded any transaction whereby it is proposed that stock in another controlled corporation or preferred stock in any other corporation be transferred to the new corporation in a taxable transaction.\textsuperscript{70}

\textbf{G. Deciding Which Assets Should be Transferred In}

When a business which has operated for a time in non-corporate form is to be incorporated, the assets should be carefully studied with the view of retaining some of them in the hands of the individuals.\textsuperscript{71} For instance, careful consideration should be given to withholding encumbered property where necessary to avoid the problems discussed at page 20 above; to withholding installment obligations because to transfer

\textsuperscript{67} The annual dollar limitation of the section puts a premium on spreading the transfers to the corporation over a period of years rather than bunching all into one year. Indeed, it appears that the individual may acquire the property, lease it to the corporation claiming the benefits of §179 personally, and thereafter sell it to the corporation which may in turn claim additional benefits under §179. This provides an alternative to the corporation’s purchasing the property direct even where it is new property subject to accelerated depreciation under §167(c)(2).

\textsuperscript{68} This is accomplished by cross reference to §267(b), the same section which applies to disallowance of losses (see note 55, supra) and by incorporating a modified version of the ownership attribution rules of §267(c).

\textsuperscript{69} Cf. §1235(d), as amended by Technical Amendments Act of 1958, §54, (relating to patents) and §1239(a)(2) (relating to depreciable property generally). It will be noted that §179 is limited to tangible property. See §167(c) which also excludes intangibles from declining balance and sum-of-the-digits depreciation.

\textsuperscript{70} §§304, 306.

\textsuperscript{71} See discussion supra, p. 76, regarding use of multiple entities.
would accelerate the deferred profit;\textsuperscript{72} and to withholding items upon which the individual may realize a usable loss by sale to outsiders. Similarly, consideration should be given to withholding items affording the individual special benefits which would not be available via the corporation. In this category are tax exempt bonds, property as to which the individual has elected accelerated depreciation,\textsuperscript{73} and emergency facilities where the certificate of necessity may not be transferable.

Further, it is frequently advisable to retain even assets, the use of which is needed by the corporation. Use by the corporation can be arranged — if precautions are observed which are discussed below — by a lease or license from the shareholder so long as the rental or royalty charged is not excessive and the genuineness of the lease or license demonstrable.\textsuperscript{74} Thinning the corporate capital in this fashion has one advantage over similarly thinning the capital by transfer of the assets to the corporation for evidences of indebtedness: Shareholder loans not only look worse to creditors of the corporation but tend to attract closer scrutiny by the Internal Revenue Service. Yet the shareholder lease or license may accomplish the same desirable objectives as the more orthodox method. It removes some of the assets from the risk of the business and thus protects the shareholder and his family. It assures an income to the shareholder and to his family — an income which will continue notwithstanding the death or disability of the shareholder. And it results in withdrawal of cash from the corporation in a form deductible by the corporation, thus avoiding the double taxation of corporate earnings which would otherwise result, and retarding the accumulation of earnings exposed to the penalty tax. Finally, a decision to withhold assets can always be reversed, while great difficulties must be surmounted to withdraw assets once they have been put into the corporation.

These reasons are so persuasive that the matter of transferring into the corporation as few assets as reasonably possible in the circumstances should be carefully weighed in every incorporation of a going business.

H. CHOOSING THE RIGHT CAPITAL STRUCTURE

1. Importance of Advance Planning

Just as advance planning is important in determining the assets which shall be put into the corporation, it is equally important in deciding what consideration the corporation shall give in exchange for those assets.

\textsuperscript{72} § 453(d).

\textsuperscript{73} Under § 167(c) the corporation would not be entitled to accelerated depreciation because it would not commence the "original use"

\textsuperscript{74} Magee-Hale Park-O-Meter Company, 15 CCH Tax Ct. Mem. 254 (1956); Nelson v. Commissioner, 203 F.2d 1 (6th Cir. 1953); Differential Steel Car Company, 16 T. C. 413 (1951), acq., 1951-2 CUM. BULL. 2; cf. § 482.
Furthermore, decisions as to the classes of stock to be issued, the corporate debt structure, and the relationship between debt and stock have important tax consequences to both stockholders and corporations.

In general, making the right decision at the time of organization is important because the capital structure set in motion then may generate or avoid later tax problems. Moreover, making a definite decision as to the character of the capital structure and sticking to it are important. If the character of the advances to the corporation is not determined with certainty, the taxpayer may feel that at a later date he can take the position most favorable to himself; but by the same token, it is also likely that a Revenue Agent will then interpret an uncertain situation in a manner most favorable to the Government — and to the disadvantage of the stockholder or corporation.

A specific reason for advance planning is that certain types of stocks or securities can be issued on incorporation without unfavorable tax consequences, whereas attempting to issue such stock or securities at a later date will clearly result in an unfavorable tax position. This is likely to be true of preferred stock, discussed below at page 99. It is also generally true of securities (long-term notes or bonds). Thus, on organization of a corporation, securities may be issued to stockholders tax-free. However, the law has an express provision treating a distribution of securities to stockholders as a taxable distribution where not in connection with the organization of the corporation. The principal amount of the securities received by a stockholder may be treated as giving rise to an ordinary dividend (or in some cases as capital gain), a result that could have been avoided had the securities been issued initially by the corporation at the time of the original issuance of stock. Stockholders owning debt may switch from debt to stock of the corporation without tax consequences, but not vice versa.

Another specific reason for pre-incorporation planning of the capital structure is that the nature of stock or securities issued and who owns them can affect tax planning in other areas. Thus, applicability of certain tax rules depends upon the kind of stock issued by the corporation. For example, the election, under new Subchapter S, not to be subject to the corporate income tax is available only to a corporation which has only one class of stock. Under other provisions of the law, the existence of

75. See discussion supra p. 19.
76. § 356.
77. § 356(d) (2) (B).
78. § 1371 (a) (4). Other situations, where tax benefits require only common stock, include deduction of interest and taxes of cooperative apartment corporations (§ 216) and ordinary loss deduction on stock of small business corporations (§ 1244(c)).
more than one class of stock may prove a benefit or detriment and in any event will bring into play special rules, such as in determining eligibility to file consolidated returns,79 "control" of a corporation for various other tax purposes,80 treatment of stock redemptions,81 and the tax consequences of other transactions.82 Other tax benefits or plans may be affected by the extent of debt in the capital structure as distinguished from stock. For example, availability of the new relief provisions for collapsible corporations depends, in part, on whether appreciation of ordinary income assets does not exceed 15 percent of the corporation's net worth (which in turn may depend on whether advances to the corporation are classed as debt or stock).83 And, of course, whenever tax treatment depends upon the nature or ownership of stock, it is vital to be able to determine with certainty whether so-called debt will be treated as stock.84

On the other hand, where favorable tax consequences are sought from the use of debt, advance planning may be necessary to assure that so-

79. § 1504. The definition of "affiliated group" requires ownership of 80% of the combined voting power of all classes of stock and 80% of each class of non-voting stock other than non-voting stock which is limited and preferred as to dividends. § 368(c). Note the difference in treatment of non-voting stock from that in the case of consolidated returns, note 79 supra. A still different 80% rule with respect to non-voting stock is found in §§ 332 and 334(b)(2) (relating to corporate liquidations). In many other areas "control" is determined from the percentage in value of all stock (e.g. §§ 267, 303, 341(d) and (e), 382, 542, 543, 1239, and 6160), in which cases "control" could turn on the value of non-voting stock. But see §§ 269, 304, 503(c) and 1551 where "control" is a percent of voting power or a percent in value of all classes of stock (both rules are used in the same subsection in § 341(e)(8), relating to collapsible corporations). See also § 333 where only voting stock counts; §§ 165(g)(3) and 582(b) where the requisite percent of each class is required.

80. "Control" for such purposes as tax-free exchanges on the organization or reorganization of a corporation requires ownership of 80% of the combined voting power of all classes of stock and 80% of the total number of shares of all other classes of stock. See discussion infra p. 95.

81. § 302. See discussion infra p. 95.

82. In addition to the references in note 80, see for example, § 421(d)(1)(C) (special rule for stock options issued to owner of 10% of voting stock); § 305(b)(1) (taxation of distributions in stock or stock rights of a corporation in discharge of arrearages of preference dividends).

83. § 341(e)(2). Compare § 1244(c)(2) (defining equity capital of a "small business corporation" as including, in effect, indebtedness to shareholders). Excess profits taxes have historically allowed a greater rate of return (before imposition of the tax) on equity capital than on borrowed capital. See § 437 I.R.C. (1939); Tri-State Realty Co. 12 T. C. 192 (1949), aff'd 180 F.2d 593 (5th Cir. 1950) where the taxpayer argued advances were equity capital.

84. If "debt" is treated as a preferred stock, situations referred to in notes 79 through 83 could be affected. See Gooding Amusement Co. v. Commissioner, 256 F.2d 159 (6th Cir. 1956), aff'd 332 F.2d 848 (5th Cir. 1954).
called debt will be treated as debt. Careful scrutiny should be expected from the Government's representatives to determine whether shareholders' loans to a close corporation are debt or equity. While such scrutiny frequently stems from situations where equity capital is thin as compared with borrowed capital, it may, as we shall see later in greater detail, be based on a number of reasons.  

The tax advantages sought on the corporate side from thin capitalization are generally derived from the fact that (a) interest is fully deductible as a business expense, while dividends are not, and (b) the existence of debt (particularly to outsiders) may reduce a corporation's exposure to the additional tax on accumulated corporate earnings. This penalty tax, as we shall see at page 72 below, imposed upon earnings of the corporation which are determined to be unreasonably accumulated for the purpose of avoiding dividend tax on shareholders. The need to retire debt is a partial, and in some cases a complete, answer to the assertion that earnings are being unreasonably accumulated.

For the person investing money in a corporation, the tax advantages usually sought from taking debt instead of stock are that (a) the corporation will be in a better position to pay interest or repay advances because of the tax advantages to the corporation previously cited, and (b) funds can be withdrawn from the corporation as repayment of loans.

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85. See infra p. 33. A recent book devoted entirely to this subject is LOR, THIN CAPITALIZATION (1958).
86.  § 163, but see exceptions under §§ 264, 265, 266 and 267.
87.  Trico Securities Corp., 41 B.T.A. 306 (1940) non acq., 1940-1 CUM. BULL. 9.  The listing of tax advantages is not intended to belittle the importance of non-tax factors in determining the right capital structure, including the corporation's business credit position and the extent to which the corporate earnings can carry interest charges or preferred stock dividends.
88.  Generally the difference in treatment to the recipient of interest and dividends is not significant. Interest is fully taxable, while dividends are taxable only to the extent of earnings and profits of the corporation. §§ 301, 316. There is also a $50 per year dividend exclusion and a 4% credit against tax for dividends received. §§ 116, 34. However, dividends received by a corporation may, by reason of special deductions allowed, be 85% tax-free (§ 243(a) ) or 100% tax-free in the case of certain investment companies, such as small business investment companies (§ 243(b)).
without tax,\textsuperscript{89} whereas a distribution in redemption of shares may give rise to a taxable gain or dividend.\textsuperscript{90}

By the same token, the failure of so-called debt to be recognized as such for tax purposes can result in loss of the above advantages and consequently, in additional taxes. Moreover, as previously indicated, much other corporate tax planning depends upon whether an instrument is debt or stock, and thus the treatment of debt as stock in a thin capitalization situation can have ramifications greater than the loss of the immediate tax advantages just cited.

One of the other tax reasons frequently cited for advancing money as debt rather than stock is that, should the business fail, a bad debt loss\textsuperscript{91} is deductible as a short-term capital loss, whereas a worthless stock loss is deductible only as a long-term capital loss.\textsuperscript{92} However, the enactment of the "Small Business Tax Revision Act of 1958"\textsuperscript{93} requires a re-examination of this reason and perhaps a reappraisal of the whole concept of receiving debt paper for a major portion of the advances to a close corporation.

Those qualifying under the above Act are allowed \textit{ordinary loss} up to $25,000 a year ($50,000 on a joint return) for loss on stock of a "small business corporation" as defined in the law. Only common stock qualifies for this ordinary loss treatment. The loss is available only to an individual\textsuperscript{94} to whom stock is issued by the corporation for money or

\textsuperscript{89} But retirement of a bond may result in capital gain where the principal amount received is greater than cost, § 1232(a) (1), or in ordinary income to the extent of the "original issue discount" in some cases, § 1232(a) (2) (A).

\textsuperscript{90} § 302(d).

\textsuperscript{91} § 166(d). In exceptional cases where purchase of a security is a requisite to a business transaction, a loss on disposition of the security may give rise to an ordinary loss. Rev. Rul. 58-40, 1958 INT. REV. BULL. No. 7 at 19; Tulane Hardwood Lumber Co., 24 T.C. 1146 (1955).

\textsuperscript{92} § 165(f) and (g). The Internal Revenue Service also recognizes that an ordinary loss may be realized on stock acquired to obtain inventory. Rev. Rul. 58-40, 1958 INT. REV. BULL. No. 7 at 19. The difference between short-term capital losses and long-term capital losses is primarily in their use against capital gains. Where a taxpayer has both long-term capital gains and short-term capital gains, short-term losses are offset first against short-term gains. This is an advantage inasmuch as short-term capital gains would otherwise be taxable in full, whereas long-term capital gains are taxable only in part. Hence, where a taxpayer has both long-term and short-term capital gains, the treatment of a loss as a short-term loss can result in less tax than if the loss were treated as a long-term loss.

\textsuperscript{93} Small Business Tax Revision Act of 1958, adding § 1244 to the Internal Revenue Code.

\textsuperscript{94} This does not include an estate or trust. The individual must be the initial owner or a member of a partnership which initially acquires the stock.
property (not stock or securities). The stock must be issued under a plan adopted after June 30, 1958, to offer such stock for a specified period, not in excess of two years, and at the time such plan was adopted, no prior offering can be outstanding.

This special treatment is available only if the corporation meets certain tests. In general, corporations deriving 50 per cent or more of their aggregate gross receipts from royalties, rents, dividends, interest, annuities or sales or exchanges of stock or securities are excluded. Moreover, the corporation must be a "small business corporation" at the time the plan for offering the stock was adopted. Such a corporation is one (a) which has no more than $1,000,000 in equity capital, including the stock which may be offered under the plan, and (b) whose capital paid in after June 30, 1958 does not exceed $500,000.

This new treatment of stock losses is a turnabout, giving more favored treatment to stock losses than to losses on loans. This suggests that in forming a close corporation, which can qualify, attention should be given to issuing a greater portion of common stock, particularly where the business is risky. No hard and fast rule can be stated as to the proper proportions, but this new treatment emphasizes the importance of taking all factors into account in planning the capital structure.

2. Thinning Capital with Loans from Outsiders

Ordinarily financing considerations (i.e. the need for or ability to obtain capital from outsiders) will determine the extent to which capital may be sought from outsiders. There are, however, a number of tax considerations which bear on whether outsiders' capital should be obtained and whether such capital should be put into the corporation in the form of debt or stock.

If outsiders' advances are intended to be debt, then it will be important to the corporation and the creditors that the tax advantages of debt treatment are obtained. Uncertainty as to such treatment can arise where the creditors are given paper which has attributes of stock. The
problems of "queer" paper arise where interest is not payable at fixed times; where principal is not repayable in all events; or where the maturity is unreasonably or unusually long. Similarly, the question of whether advances are truly debt may arise where there is a relationship between the "outsider" and stockholders. In such cases, the conduct of the creditor in enforcing his rights may be important in determining the treatment of the capital structure.

Outsiders' loans may also serve a tax purpose of stockholders in minimizing the thin capitalization problem. Since this problem generally arises from excessive debt financing by stockholders as compared with their equity investment, loans from outsiders can be favorably used in a number of ways. First, loans from outsiders to the corporation, guaranteed by the stockholders, can serve the purpose of keeping the stockholders' equity investment at a minimum and yet substantially avoid the charge that the loans are not debt. Secondly, outsider debt can also establish the pattern of loans or terms of loans for stockholder debt; i.e. give a basis for treating all such loans as debt. Thirdly, outsider loans are generally not included in the ratio of debt to stock in considering the thinness of the capitalization, and hence outsider loans may permit a layer of stockholder loans (whereas if the total debt were to stockholders it might all be treated as equity). Finally, outsider loans may make the debt structure disproportionate. One of the principal danger areas in stockholder debt exists where debt is held proportionate to stock. Outsider debt will break this pattern.

The use of outside loans guaranteed by shareholders is a significant development in the avoidance of the treatment of stockholder debt as equity. It is important in pre-incorporation planning because outsider loans at the time of organization can get the corporation over the critical first period when stockholder loans are most likely to be considered part of the risk capital. Later, outsider debt may be switched to shareholder debt if desirable.

3. *Thinning Capital with Loans from Shareholders*

Shareholders have a legitimate desire to minimize the amount of their capital subject to the risk of the business and to be in a position to with-

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98. For a more detailed discussion of the form of the paper see *infra* p. 33.
99. At one time it was thought there was some advantage in guaranteeing the outsider loan because an ordinary loss rather than a capital loss could be obtained. This has been denied by the Supreme Court. Putnam v. Commissioner, 352 U.S. 82 (1956); 57 COLUM. L. REV. 577 (1957). However, a business bad debt may be obtained by the person in the business of lending or guaranteeing funds for business. Gandy v. Squire, 57-1 U.S.T.C. § 9408 (D.C. Wash. 1957).
100. See *infra* p. 36.
101. See Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941).
draw part of their funds without dividend treatment. If loans from outsiders can be obtained, then at least the first part of this desire can be satisfied with a minimum of tax problems. Frequently, however, sufficient outsider loans cannot be obtained and in such cases there should be a full realization of the tax risks that are involved in stockholder debt.

The purpose of pre-incorporation planning in connection with stockholder debt is to be assured that the entire record will sustain the taxpayer's position that which he considers as debt will be so recognized for tax purposes. This requires consideration of many factors. Early cases looked to the form or nature of the paper to determine whether it reflected a debtor-creditor relationship or a stockholder relationship with the corporation.\textsuperscript{102} Subsequent decisions have evolved a test of whether a debtor-creditor relationship was "intended."\textsuperscript{103} These cases have not brought clarification under the law because, depending upon the facts of each case, "additional factors" are being cited by the courts. No one of the factors is said to be determinative and some of them, while possibly having an application in a particular case, would make no sense if applied as a matter of principle to other cases. However, the principal guides to be followed in pre-incorporation planning are the following:

(a.) Name and form of debt. The corporate debts to stockholders should be in such form that they have all of the formal incidents of debt. While calling an instrument debt and meticulously observing the usual forms of debt will not guaranty tax treatment as debt,\textsuperscript{104} nevertheless, failure to do so is likely to be fatal.\textsuperscript{105} The difficulties involved in "queer paper" have already been referred to, and while the courts have sustained, as debt, instruments containing some unusual provisions,\textsuperscript{106} nevertheless such court tests should be avoided if possible.

\textsuperscript{102} Kelley Co. v. Commissioner, 326 U.S. 521 (1946).
\textsuperscript{103} See e.g. Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); on remand, 17 CCH Tax Ct. Mem. 29 (1958).
\textsuperscript{105} Stockholder advances on open account would appear to have the greatest exposure, Miller Safe Co., Inc., 12 B.T.A. 1388 (1928); Morris Plan Company of Binghamton, 26 B.T.A. 772 (1932); Transportation Service Associates, Inc., 3 CCH Tax Ct. Mem. 135 (1944); but this may depend on the amount and temporary nature of the loans, i.e. early repayment.
\textsuperscript{106} See John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), and Glaser & Sons, Inc., 3 CCH Tax Ct. Mem. 611 (1944) both holding interest deduction allowed on bond where 8% interest was to be paid only from earnings and was non-cumulative; other requirements held satisfied. See also Idaho Dept. Store, Inc., 3 CCH Tax Ct. Mem. 157 (1944) and Proctor Shop, Inc., 30 B.T.A. 721 (1934),
(b.) **Reasonable expectation of repayment in accordance with terms.**
The circumstances surrounding the issuance of debt should support the intended nature of the instruments as debt.\(^{107}\) Circumstances indicating that the stockholders advances were intended to serve a continuous purpose in the nature of permanent capital of the business are indicative of stock rather than debt. Thus, to support a case for debt, when the advances are made there should be a reasonable expectation of repayment.\(^{108}\) If there is, the fact that the due date is extended should not be fatal.\(^{109}\) However, where a court finds that it is unlikely that provisions for payment will be enforced, it is an easy jump to the conclusion that "debentures" are stock.\(^{110}\)

(c.) **Free transferability.** Transferability of debt should be permitted; restrictions on transfer may create a problem.\(^{111}\) A "package deal" under which bonds are not to be sold without the sale of stock, may be used as an indication that the indebtedness is part of the capital investment by the stockholders.\(^{112}\)

(d.) **Equity capital not unreasonably small.** Of prime importance in determining whether debt was intended to be debt or part of the permanent capital are the facts pointing to whether the funds invested in stock were commensurate with the scope and risk of the business; or whether considering the nature of the business, the amounts paid in not only for stock but also for debt securities were necessary to the capital of the business.\(^{113}\) This permits a subjective test and the danger of the

\(^{107}\) See Gooding Amusement Co., 23 T.C. 408, 418 (1954) (notes held to be stock) citing Proctor Shop, Inc., 30 B.T.A. 721 (1934), *aff'd* 82 F.2d 792 (9th Cir. 1936) (holding "debenture preference stock" to be debt).

\(^{108}\) Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); *on remand*, 17 CCH Tax Ct. Mem. 29 (1958). See also Emanuel N. Kolkey, 27 T.C. 37 (1956).


\(^{111}\) Talbot Mills v. Commissioner, 326 U.S. 521 (1946) (notes transferrable only by owner's endorsement and notation on corporation's transfer books).


\(^{113}\) Earle v. W. J. Jones & Son, Inc., 200 F.2d 846 (9th Cir. 1952); Sam Schnitzer, 13 T.C. 43 (1949) *aff'd per curiam* 183 F.2d 70, (9th Cir. 1950), *cert. den.*
substitution of a Revenue Agent's or a court's judgment as to how a business should be financed, particularly on a hind-sight basis. This difficulty may be reduced by including results of an investigation of comparable companies to show their capital structure and a history of success with similar capital as a part of the record of consideration at the time of the organization of the corporation.\textsuperscript{114}

(e.) \textit{Reasonable ratio of debt equity}. The rationale of looking to the ratio of debt to equity for an indication that debt is stock is derived from dictum expressed by the Supreme Court which indicated that a nominal stock investment and an obviously excessive debt structure may be evidence of an intent to avoid taxes by an interest deduction.\textsuperscript{115} However, recent cases and at least one Circuit Court have rejected a high ratio as determinative of the issue of indebtedness. The present tendency seems to be to look more to the "business purpose" of creating debt.\textsuperscript{116} The debt-stock ratio, however, has a practical significance since it is so easily seized as an outward indicia of thin capitalization. Therefore, a ratio of 3 to 1 or 4 to 1 may, on the face, be some protection. In determining this ratio, the fair value should be used for assets or stock and not just book value.\textsuperscript{117} Moreover, outside debt should be weighed in determining the total debt structure although it may not be used in the thin capitalization ratio.\textsuperscript{118}


\textsuperscript{116} See John Kelley Co. v. Commissioner, 326 U.S. 521, 526 (1946). However, the Tax Court has held that the "thin capitalization" is not the only basis for determining that tax avoidance was a substantial purpose in the issuance of notes. Gooding Amusement Co., 23 T.C. 408, 420-21 (1954).

\textsuperscript{117} Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957). The Tax Court has indicated that the ratio is significant in strengthening the inferences from other factors. Isidor Dobkin, 15 T.C. 31 (1950) \textit{aff'd per curiam} 192 F.2d 392 (2d Cir. 1951). But see J. I. Morgan, Inc. 30 T.C. 89 (1958) (ratio of 50:1 approved); 250 Hudson St. Corp., 5 CCH Tax Ct. Mem. 722 (1946) (common stock stated value $5; income debenture notes issued in exchange for $750,000 preferred stock; notes held valid debt). See also Clyde Bacon, Inc., 4 T.C. 1107 (1945); Idaho Lumber & Hardware Co., 4 CCH Tax Ct. Mem. 290 (1945).

(f.) Disproportionate ownership of debt and stock. This is another factor which is likely to be taken as an indication of "intent" in connection with debt. Where debt is proportionate to stock, it may be taken as an indication that the stockholders lacked confidence in the repayment of their loans and therefore that they contemplated their loans would be at the risk of the business (i.e. part of the "venture capital"). The fact that debt is not proportionate to stock has supported a finding of debt, but minor variations are not likely to be considered as significant. However, reasons for the advances are still determinative, whether proportionate or not proportionate.

(g.) Lack of subordination. Where the debt is subordinated to general creditors, this factor may be seized on as an indication that the debt has one of the prime characteristics of stock. However, subordination is not conclusive; "debt is still debt despite subordination." Here too all of the facts must be considered as to the intent of the stockholders to enforce their claims.

(h.) Adequate security. This factor, like that of subordination is not conclusive, but security is an indication of an ordinary debtor-creditor relationship. Thus a "guaranteed stock" secured by a mortgage and having priority over general creditors was held to be debt.

119. See Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957).
122. See Gooding Amusement Co., 23 T.C. 408, 422 (1954) (payment of interest held dividend even though 24 percent of stock held by employees who did not make loans). The relationship between the parties would also seem to be a factor in ignoring any disproportion.
123. See Wetterau Grocer Co. v. Commissioner, 179 F.2d 158 (8th Cir. 1950); 1432 Broadway Corp., 4 T.C. 1158 (1945), aff'd 160 F.2d 885 (2d Cir. 1947).
128. Helvering v. Richmond, Fredricksburgh & Potomac R.R. Co., 90 F.2d 971 (4th Cir. 1937); but to the contrary where under Ohio decisions, the stock was
other hand, the security of a chattel mortgage has been held immaterial where there were no other creditors. 129

(ii) Other factors. Other factors which may be important in individual cases include the use to which the loans are put (e.g. whether for capital assets, etc.), 130 whether the loans or debentures were substituted for stock in the capital structure, 131 representations to others (e.g. financial reports) whether the advances are loans or capital, 132 whether notes and stock are issued in exchange for the same assets, 133 and whether there is any basis for distinguishing among layers of debt or advances made at different times. 134

It is clear that there is no one single factor under the present law which will serve to insulate stockholder debt from being treated as equity. 135 It therefore behooves the taxpayer or his representative to act carefully and cautiously in this field. Certainly the use of outside debt to the greatest extent possible would be in order to minimize the problem, even if a shareholder pledge of assets or shareholder personal guarantee is necessary. Other suggestions are:

(1.) Limit the ratio of debt to equity in advance so that you will have a clearer guide-line and stay within your own reasonable limitation.

(2.) Do not over-reach.

(3.) Make a clear record, that is, avoid mingling of debt and stock; avoid inconsistent representations; see that the corporate records and

subordinate to general creditors. Dayton & Michigan R.R. Co. v. Commissioner, 112 F.2d 627 (4th Cir. 1940).

129. Est. of Herbert B. Miller, 24 T.C. 923 (1955), rev’d 239 F.2d 729 (9th Cir. 1956).


132. See Crown Iron Works Co. v. Commissioner, 245 F.2d 357 (8th Cir. 1957) (corporate security shown as capital for credit purposes).


134. See Huffstutler, 12 CCH Tax Ct. Mem. 1422 (1953) where of $13,230 stockholder debt the court held that only an initial $8,500 was equity.

135. Legislation is being considered which would provide the following non-exclusive qualifications for recognizing stockholder debt as debt; definite maturity, reasonable interest, payments (principal and interest) not dependent on earnings, non-subordination to general creditors, limited ratio of shareholder debt to stock. 81 A.B.A. REP. 160-61 (1956); AM. LAW INST. FED. INCOME AND GIFT TAX PROJECT FOR 1957-58, at 59, 65. Report of Advisory Committee to Ways and Means Committee (1957) § 10. The recommended permissible ratios vary from 3:1 to 10:1.
minutes of meetings give the reasons for loans which satisfy the factors of intent that would be present in the case of outsider loans.

(4.) Take such actions as will minimize the problem by spreading the risk in connection with stockholder debts, such as by using layers of debts, that is, exposing the corporation and the stockholders only with respect to certain loans or notes which are kept separate from other loans and notes by their terms or other provisions. Also, time the principal payments to make repayments as soon as possible, thereby making a record of temporary loans to the business.

(5.) Having set the terms of the debt, follow them implicitly. Treat the debt as if it were owed to an outsider.

4. Using Several Classes of Stock

Advance planning as to classes of stock is just as important as planning for debt. As previously indicated, different classes of stock can be created upon organization of the corporation which — particularly if they are preferred — would create serious problems if issued in a later reorganization. If the business prospers, existence of these classes of stock can be a distinct advantage. On the other hand, generally, the various classes of stock can be converted to common stock without tax consequences later if necessary.

Separate classes of stock may serve various purposes for both tax and non-tax reasons. One purpose may be in connection with dividends. Thus, creating different classes of stock with different rights as to dividends enables the corporation to pay dividends on one class without paying dividends to holders of another. For example, stockholders who may be officers of the corporation may not want or need dividends, whereas others who are not on the payroll may.

Non-voting stock (whether common or preferred) may serve a number of purposes of both the corporation and shareholders. Non-voting stock may be used in connection with employee incentive plans of various kinds. For example, non-voting stock of the corporation may be contributed to an employee stock bonus trust or purchased by such an employee trust, to build up a fund for employees representing an equity in the business. Such an employee's trust may be established and contributions made to it by the corporation without tax to the employees. Likewise, non-voting stock may be used for stock option plans or stock

136. Subsequent reclassification of stock to give stockholders a choice between stock paying cash dividends and that paying stock dividends may result in stock dividends being taxable. Proposed amendment of Reg. § 1.305-2 announced in Federal Register July 10, 1956.
bonuses paid directly to employees. Thus, without surrendering control of the business, an interest in the equity or growth of the corporation may be afforded employees through such incentive plans.\textsuperscript{187}

Non-voting stock can also serve many purposes of stockholders in connection with family, charitable gifts and estate planning. Thus, the father who desires to transfer part of his income-producing property to his children can make gifts of non-voting stock which may provide them with dividend income without affecting his voting control of the corporation. Similarly, non-voting stock may be used for gifts to charitable organizations.\textsuperscript{188} Non-voting stock also serves an important role in estate planning, since such stock may be used for gifts to members of the family who are not active in the business, \textit{i.e.} widow and daughters, whereas voting stock can be reserved and given to sons who are active in the business.\textsuperscript{189} Likewise, where stock is to be redeemed by the corporation to pay death taxes,\textsuperscript{140} non-voting stock may be surrendered by the estate for this purpose to produce cash for the estate without affecting the voting control of the corporation.

\textit{Preferred stock} can also play an important role in corporate and stockholder planning. It should be particularly kept in mind that preferred stock issued on organization of the corporation is not tainted under Section 306. Subsequent distribution of preferred stock after the corporation has engaged in profitable operations, however, can result in such stock being tainted, that is, its sale or redemption may give rise to ordinary income. In general, a non-voting preferred stock can serve several useful purposes. These stem primarily from the fact that such stock has a fixed redemption price and hence a determinable or fixed value. Thus it can be made the subject of gifts of known value for gift tax purposes; it can be redeemed after the death of the stockholder at a fixed value to pay estate taxes; it can freeze or limit the amount subject to estate tax, and it can be passed on to members of the family to provide a fixed income and security as an investment.

Preferred stock can also act as a lever to reduce or depress the value of the common stock, and thus, through a low price for the common stock, greater flexibility can be achieved in plans for making common stock available to employees or others where there is a desire to have

\textsuperscript{187} These and other plans are discussed \textit{infra} p. 99.
\textsuperscript{188} See Sugarman, \textit{Foundations Established for Corporate Giving}, N.Y.U., 14TH INST. ON FED. TAX 77 (1956).
\textsuperscript{140} § 303. See discussion \textit{infra} p. 83.
them buy into the business.\footnote{141} Likewise, the common stock can be passed on to members of the family who are active in the business, whereas the preferred stock can be left to other members of the family who are not active and to whom security of investment is important for income purposes. Furthermore, preferred stock need not immediately provide for cumulative dividends and thus on incorporation a stock may be issued as a non-voting preferred stock (i.e. preferred on liquidation) with a provision for cumulative dividends to take effect at a subsequent date.

Before creating various classes of stock for the tax advantages cited above, a check should be made as to the affect of having several classes of stock on other aspects of tax planning as previously described at the outset of this discussion of the capital structure.

I. Restrictions on Transfers of Shares

Pre-incorporation planning with respect to the capital structure of the corporation would be incomplete without consideration of restrictions on transfer of shares of the close corporation. The business and stockholder reasons for such restrictions are clear: the stockholders want to restrict the ability of others to foist new “partners” on them; and continuity of management, where ownership and management are close, is best served by restrictions on transferability of stock of the corporation. Moreover, the restriction on transfer of shares of the corporation is closely aligned with the necessity that, upon the death of a shareholder, his estate be able to realize cash from his stock in order to pay estate taxes\footnote{142} or for other reasons to provide cash for the deceased stockholder’s family. Therefore, restrictions on transfer and the ease of bail-out are kindred factors to be considered upon organization of the corporation.

There are many factors to be taken into account in deciding where or how restrictions on transfers or bail-out of stock should be provided. Aside from considerations of state law, there are several important tax factors to be taken into account. The most common use of restrictions is in connection with buy and sell agreements; but these involve certain dangers from a tax standpoint. For detailed discussion see infra p. 87.

Restrictions on stock may also serve another purpose in connection with employee incentive plans. Restrictions on transferability by employees and the right of the company to buy the stock at a fixed or determinable price in the event an employee leaves his position may serve two purposes from a tax viewpoint. One purpose may be to de-
press or fix the value of the stock which may be given to employees as a stock bonus. This serves the purpose of limiting the amount which may be considered as compensation to the employee.\textsuperscript{143} Another purpose is to fix a value of stock so that the close corporation may issue stock options which qualify as “restricted stock options” under the Internal Revenue Code. As indicated in the subsequent discussion, the principal difficulty of a closely held corporation using stock options as an incentive to employees is that the value of the stock must be determinable at the time the option is granted; restrictions on transfer of stock may be used to set a maximum value for this purpose.\textsuperscript{144}

II. Post-Incorporation Planning

In the preceding, we have dealt with the various matters which require consideration prior to the actual formation of the new corporation. Once we have resolved these questions and have completed formation of the corporation, a new set of problems must be faced, some almost immediately and others as the corporation matures and grows.

A. Making the Most of the Corporation’s New Taxpayer Status

Because the corporation is a new taxpayer, certain elections are permitted to it which, if properly handled, can conserve and enhance the working capital.\textsuperscript{145} Many of these elections can be made freely at the outset but would entail serious problems and possible disadvantages if elected at a later time. Therefore, it is important that careful consideration be given to the several areas where such elections are possible and care should be taken that proper and timely action is taken to avail the corporation of them.

1. Selection of the Taxable Year

As a taxpayer, the new corporation is not bound by the accounting period used by its predecessor.\textsuperscript{146} It is free to elect a taxable year with-

\textsuperscript{143} Robert Lehman, 17 T.C. 652 (1951); Harold H. Kuchman, 18 T.C. 154 (1952).

\textsuperscript{144} For example, where an employee is given an option to purchase stock at book value and in the event he ever wants to dispose of it, the company can buy it at the price he paid for it, then the value of those particular shares would seem to be fixed at no greater than the price paid by the employee.

\textsuperscript{145} For a comprehensive check list of various items subject to timely election, see Schwanbeck, \textit{Elections and Options Available to Taxpayer in the 1954 Code}, 32 \textit{TAXES} 748 (1954).

\textsuperscript{146} The discussion of the various elections available to the new corporation does not cover reorganization transactions within § 381(a) where the new corporation may not be free to elect but is bound by the treatment of a predecessor.
out having to obtain the approval of the Internal Revenue Service. Subject only to the requirement that its taxable year must coincide with the accounting year which it uses on its books,\textsuperscript{147} it is free to elect the use of the calendar year, a fiscal year, or a 52-53 week accounting year.\textsuperscript{148} If a fiscal year is elected, the period will cover 12 months, and will end with the last day of a month.\textsuperscript{149} Similarly, if the calendar year is selected, the period will cover 12 months and will end on December 31.\textsuperscript{150} The first return, however, may cover a period of less than 12 full months.\textsuperscript{161} Basically, the choice is between the use of a calendar year and the use of a fiscal year. Sometimes this choice will be governed by nontax considerations such as the desirability of taking inventory at the end of the accounting period and having this fall at a time when business is not at a peak.\textsuperscript{162} In other cases, there may be distinct advantages from the viewpoint of federal income tax which will govern the selection of the taxable year.

In view of the fact that the first taxable year may cover a period of less than 12 months, the new corporation may legitimately choose to close its first taxable year at the end of the month when its income has reached approximately the $25,000 level so as to limit the tax on its first year's income to the 30% rate.

The election as to the taxable year is effective by filing the initial tax return within the time prescribed by law using the taxable year which is chosen.\textsuperscript{163} Since the return is not due until the 15th day of the third calendar month following the close of the taxable year, management has an opportunity to reach its decision as to the closing of its first taxable year with the benefit of some hindsight.\textsuperscript{164} It should be emphasized, however, that the period used as the first taxable year must

\textsuperscript{147} Reg. § 1.441-1(c).
\textsuperscript{148} § 441(a); Reg. § 1.441-1(b) (3). Where the corporation cannot qualify for the use of a fiscal year or a 52-53 week accounting year, it must use the calendar year. § 441(g); 3 CCH 1958 STAND. FED. TAX REP. ¶ 2761.02.
\textsuperscript{149} § 441(e).
\textsuperscript{150} § 441(d).
\textsuperscript{151} Reg. § 1.443-1(a) (2).
\textsuperscript{152} Such other considerations as coordinating the tax year end with a time when data may be needed for annual shareholder meetings, state tax returns or credit purposes may control the selection of the taxable year.
\textsuperscript{153} § 6072(b); Reg. § 1.441-1(b) (3); 5 CCH 1958 STAND. FED. TAX REP. ¶ 5138.01.
\textsuperscript{154} If the decision as to the close of the first tax year is reached at a late date but prior to the due date for the return, the corporation can secure an automatic extension of time of three months within which to file its tax return by the timely filing of Form 7004 and paying one half of the probable tax that will be due. § 6081(b). Rev. Rul., 389, 1957-2 CUM. BULL. 298.
be the same as that used for purposes of the corporate books,155 and that once the taxable year is elected, the corporation must continue to file on the same basis for future years.156

2. Election to be Taxed under Subchapter S

As pointed out earlier,157 Subchapter S permits corporations in certain limited cases to elect to be exempt from income tax. By so electing, the undistributed taxable income of the corporation is included in the income tax returns of the shareholders. By this election, the shareholders are entitled to deduct in their personal returns the net operating loss of the corporation.158 Thus, the selection of the corporation's first taxable year may be influenced by the effect to the shareholders under Subchapter S. For example, if the new corporation is expected to have operating losses during the first few months of its operation, choice of the corporation's first taxable year may be dictated by the ability of the shareholders to absorb those losses to advantage against their other income. In this connection, for the shareholders to obtain the immediate benefit of any such loss, it will be necessary that the corporation select a taxable year which ends with or within the current taxable year of the shareholders, because under Subchapter S the undistributed taxable income or net operating loss of the corporation is reported in the returns of the shareholders for their taxable year in which falls the end of the corporation's taxable year.159 In view of this rule there will be a certain amount of tax postponement where the corporation reports on the basis of a fiscal year and the shareholders report on the basis of a calendar year.160 For this reason it will generally be found advantageous, in any case where Subchapter S may be elected, for the corporation to initially select a fiscal year where the shareholders are using a calendar year.

3. Selection of Accounting Methods

In the selection of accounting methods, just as in the selection of the taxable year, the new corporate taxpayer is relatively free to use whatever accounting method it desires and does not have to obtain approval

156. Unless prior approval to make a change is obtained from the Commissioner or unless a change is otherwise permitted under the internal revenue laws or regulations. Reg. § 1.441-1(b) (4).
158. §§ 1374.
159. §§ 1373-4.
of the Internal Revenue Service. In general, any accounting method may be elected by the corporation so long as it clearly reflects income and is the method regularly used in keeping the corporate books. Where the corporation has two or more separate and distinct businesses, different accounting methods may be used in each. Of course, once an accounting method is elected, it must be consistently used in later years unless and until permission is obtained from the Internal Revenue Service for change.

In general, the election as to accounting methods is simply accomplished by use of the method selected in the preparation and filing of the corporation's first income tax return. Therefore, care and consideration should precede the preparation and filing of the initial return. Many of the details of accounting methods are matters in which a qualified accountant should and generally does participate. The scope of this article permits only the discussion of a few of the more common selections to be considered.

**Bad debts.** One basic choice that must be made on the first return is whether to treat bad debts on the actual charge-off method or on the reserve method. The actual charge-off method of treating bad debts permits the corporation to claim a deduction during the taxable year for the portion of the debt that is uncollectable and to deduct the balance in the year that the debt becomes wholly worthless, or to wait and deduct the entire debt in the year that the debt becomes wholly worthless. Since

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161. § 446(a); Reg. § 1.446-1(a) (2). Taxpayers selling real estate or regularly selling personal property may elect to report the income therefrom on the installment basis under § 453.


163. § 446(d); Reg. § 1.446-1(d). Separate books and records must be kept.

164. § 446(e); The procedure for securing such consent is set forth in Reg. § 1.446-1(e).

165. Reg. § 1.446-1(e).

166. § 166. A taxpayer can claim a bad debt deduction only to the extent of its adjusted basis for tax purposes. § 166(b). See 2 CCH 1958 STAND. FED. TAX REP. § 1619.0111. Although the selection of the method of treatment of bad debts is not required until the need arises, W. H. Langley & Co., 23 B.T.A. 1297 (1931), the new corporation should select the desired method in its first return. Permission to change must be granted. Century Die Casting, 2 CCH Tax Ct. Mem. 1066 (1943). Reg. § 1.166-1(a).

167. To sustain a partial bad debt deduction, taxpayer must claim the deduction in the return for the desired year and establish that the debt is worth no more than the remaining adjusted basis for the debt. Reg. § 1.166-1(c). It is not necessary to establish any event occurring in the taxable year for which claim is made as in the case of sustaining the deduction for a wholly worthless debt. E. Richard Meinig Company, 9 T.C. 976 (1947). Taxpayer can choose the year for the partial bad
debts generally become worthless in bad times, a bunching of the bad debt deductions frequently results in poor income years. In contrast, the reserve method for the treatment of bad debts permits the corporation to anticipate its losses and claim the deduction for the yearly addition to the reserve in years when the profits are good. Moreover, under the reserve method, the amounts deducted annually will tend to be more or less on a level basis. At the same time it should be recognized that the Commissioner has greater authority over the allowance under the reserve method than under the actual charge-off method. This is because there is a large area within which judgment may differ as to what a "reasonable" addition to the reserve may be for the particular year. The reserve method may have more of a leveling influence on net earnings in the treatment of recoveries on bad debts than does the actual charge-off method. Where the actual charge-off method is used, a later recovery, unless excepted by the statute, must be taken into income. In contrast, under the reserve method, the recovery is netted against the reserve. Therefore, it will generally be found advisable in any business where merchandising is of consequence to adopt the reserve method and to make the election on the first return filed.

Depreciation. A wide variety of choices is available to the new corporation in the treatment of depreciation on its assets. The depreciation deduction. A wholly worthless debt deduction is a factual determination. Generally, this will require showing that the debt had value at the beginning of the year and some event occurring during the year rendered the debt wholly worthless. For a discussion of bad debt treatment and cases thereon, see 5 MERTENS, FEDERAL INCOME TAXATION § 30 (1956).

168. § 166(c); Proposed Reg. § 1.166-6(b).
169. When a debt becomes worthless, in whole or in part, the amount thereof is charged to the reserve. Proposed Reg. § 1-166-6(b). Where the taxpayer charges a wholly worthless bad debt to the reserve for bad debts, the tests are the same as in the direct charge-off method. However, the corporation will generally find that the issue of whether a particular debt has become wholly worthless will be raised indirectly in the determination of the yearly reasonable addition to the reserve which requires an analysis of the amounts charged to the reserve during the year.

170. § 111(a).
171. 2 CCH 1958 STAND. FED. TAX REP. §§ 1131.01, 1624.13.
172. The claim for the bad debt itself constitutes the election to use the direct charge-off method. Union Bleachery v. United States, 176 F.2d 517 (4th Cir. 1949); cert. denied, 339 U.S. 964 (1950). Once the corporation has elected the method of treating bad debts, permission to change the method must be obtained from the Commissioner. Proposed Reg. § 1.166-1(a). Changing from the reserve method to the actual charge-off method may cause income tax consequence to the corporation in the year permission to change is granted. I.R. 2348, 1927-VI-1 CUM. BULL. 67; S. Rossin & Sons, Inc. v. Commissioner, 113 F.2d 652 (2d Cir. 1940). For the discussion as to the treatment of the reserve for bad debts in the year of liquidation, see p. 14, infra.

173. § 167(a). For a detailed discussion of depreciation see 4 MERTENS, FEDERAL INCOME TAXATION § 23 (1954).
ciable assets may be grouped or classified into accounts or the assets may be depreciated on an individual basis. Indeed, there is nothing to prevent the corporation, if it chooses, in using any reasonable method of classification. If the assets are placed in group or classified accounts, the depreciation rate used may be an average rate for the assets in the group.\textsuperscript{174} The tax treatment of retirements of assets in group or classified accounts depends upon the nature of the retirement and the group depreciation rate selected.\textsuperscript{176} It should be recognized that the election by the corporation to use individual asset accounts generally requires considerably more bookkeeping detail than does the use of group or classified accounts. Except for this factor, however, it will normally be found more advantageous to use the individual asset method than the group or classified account method.

In addition, the new corporation is entitled to elect whichever method of write-off it may choose. The cost of depreciable assets, new or used, whether depreciated individually or under the group method, may be written off on the straight-line basis, on the declining balance method using 150\% of the straight-line rate, on the unit of production basis or any other method which gives a reasonable allowance.\textsuperscript{177} Where new assets are involved, \textit{i.e.} the original use of the depreciable property begins with the corporation, it is at liberty to elect the double declining balance method or the sum of the years-digits method of depreciation.\textsuperscript{177} A different method of depreciation write-off may be used for each asset even though the asset may be one of several assets of the same type and put to the same use, providing that the corporation elects to use the individual asset method of depreciation write-off rather than the group or classified account method.\textsuperscript{178} In addition, the corporation is at liberty to elect

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  \item \textsuperscript{174} Reg. § 1.167 (b)-1 (b). Where assets have been classified in groups, normal retirements from the accounts are adjusted through the depreciation reserve. Reg. § 1.167 (a)-7 (b). See Reg. § 1.167 (a)-8 for treatment of retirements, sales and exchanges of depreciable assets. See 2 CCH 1958 STAND. FED. TAX REP. § 1726.01 for definitions of group, classified and composite accounts.
  \item \textsuperscript{175} Reg. § 1.167 (a)-8.
  \item \textsuperscript{176} Reg. § 1.167 (b)-0 (b).
  \item \textsuperscript{177} To qualify, the property must have a useful life of at least three years and cannot be intangible property. § 167 (c). In the case of acquisitions of property, the taxpayer must be the original user and must have acquired the property after December 31, 1953. In the case of construction, reconstruction or erection of property by the taxpayer, only the portion attributable to such construction, reconstruction or erection after December 31, 1953, can qualify. See § 167 (b) for all methods covered under the new accelerated provisions. For a discussion of the double declining balance method, the sum of the years-digits method and others, see Rothschild, \textit{The Case for the Declining Balance}, 33 TAXES 502 (1955) and Lasser, \textit{The New Depreciation Regulations}, 34 TAXES 741 (1956).
  \item \textsuperscript{178} Reg. § 1.167 (a)-7 (c).
\end{itemize}
of LIFO, a special election is always required,\textsuperscript{186} by filing with the return special election forms and supplying certain detailed information.\textsuperscript{187} The possible advantages inherent under the last-in, first-out method during an inflationary period may conversely prove serious should a period of deflation set in and the Internal Revenue Service refuse to grant a new election. This is another area where the decision should be made only after consultation with a competent accounting adviser.

4. Election to Amortize Organization Expense

The new corporation is permitted at its election to write-off organizational expenses over a period of not less than 60 months.\textsuperscript{188} The only alternative is to capitalize these items with the hope and expectation of eventual recoupment as a deduction in the year of liquidation. This is no real alternative.

In general, those organizational expenses which may be amortized include all those expenses incident to creation of the corporation which are chargeable to a capital account and which if incurred by a corporation having a limited life, could be amortized ratably over such life.\textsuperscript{189} Thus, legal and accounting fees incident to the organization of the corporation, incorporation fees paid to the State, cost of the organizational meeting of shareholders and directors and the like are included.\textsuperscript{190} Organizational expenses do not, however, include items of the cost of issuing or selling the stock, such as commissions, professional fees and the printing costs.\textsuperscript{191}

The deduction is available only with respect to those qualified expenses which are "incurred" prior to the end of the taxable year in which the corporation "commences business."\textsuperscript{192} Generally, professional fees are not "incurred" until agreed to or a bill is submitted. The deduction is best protected if the corporation receives such bills before the end of its first taxable year. Being aware of such proper timing is particularly important where the corporation may elect a short first taxable year.

Here again, in contrast to many of the elections permitted a new cor-

\textsuperscript{186} Textile Apron Co., 21 T.C. 147 (1953).
\textsuperscript{187} On form 970 as specified in Proposed Reg. § 1.472-3(a). The election need not be made in the first year but can be made in a later year. However, the application, to be effective, must be a part of a return that is timely filed. See Kaufman & Bear Company v. United States, 133 Ct. Cl. 510, 137 F.Supp. 725 (1956), cert. denied, 352 U.S. 835 (1956).
\textsuperscript{188} § 248.
\textsuperscript{189} § 248(b).
\textsuperscript{190} Reg. § 1.248-1(b).
\textsuperscript{191} Reg. § 1.248-1(b)(3).
\textsuperscript{192} Reg. § 1.248-1(a)(2).
whether to begin depreciation on newly acquired assets with the month of acquisition or with the month following the month of acquisition and to elect to stop depreciation with the month preceding disposition, or may, if it chooses, merely use a half year’s depreciation in the year of acquisition and the year of disposition provided the treatment is consistently followed.179

Several factors must be considered in choosing whether to elect a double declining balance method or the sum of the digits method. Under the double declining balance method, salvage is automatically taken into account because the method by its very nature provides for this. But provision must be made for salvage under the sum of the digits method.180 Furthermore, election to use the double declining balance method permits greater flexibility in the future in that the corporation is at liberty to change over to the straight-line method at any time without permission of the Internal Revenue Service.181 In contrast, change from sum of the digits method to the straight-line method of depreciation requires advance consent.

It should be kept in mind when considering the depreciation policy of the corporation that it may also elect the special first year depreciation provision permitted under the recent amendment.182

Inventory valuation. Numerous selections as to inventory treatment are also available.183 Except where last-in, first-out (LIFO) inventories are elected, the corporation is at liberty to value inventories at cost (average, standard or similar method) or at cost or market, whichever is lower.184 Again, except where LIFO inventories are used, grouping of inventories (raw material, work-in-process, finished goods, etc.) is also a matter of free choice to the corporation.185 These elections are effected simply by preparing and filing the first return on the basis selected.

The election to use the LIFO inventory method is an outstanding exception to the general rule that accounting methods are selected simply by preparing and filing the tax return on the basis selected. In the case

179. Reg. § 1.167(a)-10(b).
180. Reg. § 1.167(b)-3(a); Reg. § 1.167(b)-2(a). Where salvage is taken into account, it is determined at the time the asset is first used in the trade or business. The reasonable allowance for depreciation is determined at the end of the taxable year. Reg. § 1.167(a)-1(c). The regulations provide that in no event may any asset be depreciated below its salvage value. Reg. § 1.167(a)-1(c) and Reg. § 1.167(b)-2(a).
181. § 167(e).
182. § 179.
185. Proposed Reg. § 1.472-1(c).
poration, the first return of the corporation must be accompanied by a statement of the election together with certain other data.\textsuperscript{193}

5. \textit{Other Important Elections}

There are a number of other elections of more or less special application to particular kinds of business which are also available to the corporation as a new taxpayer. These are important in the areas where they apply, but are believed not to be of sufficient general interest to merit discussion in this article.\textsuperscript{194}

B. \textit{Arranging Executive Compensation}

1. \textit{The "Unreasonableness" Problem}

In the close corporation, the problems of compensation are often more significant from the tax point of view than from purely business considerations. Where the stockholders of the corporation are also the officers or members of the immediate families of officers, it is not important, except as it may affect the tax burden, whether the profits of the business are extracted in the form of dividends or as compensation. Dividends, however, are not deductible by the corporation for income tax purposes, and that portion of the profit which is removed in dividends is subjected to tax in the tax return of the corporation as well as in that of the individual who receives it. Proper compensation, on the other hand, is deductible in computing taxable income of the employer, and there is an inevitable temptation to reduce taxes by paying salaries in excess of what might have been paid if the officers had not also been stockholders. Compensation of executives in close corporations is, as a result, subject to close scrutiny on the part of the Internal Revenue Service, for the Code allows the deduction only of "a reasonable allowance for salaries or other compensation for personal services actually rendered."\textsuperscript{195} Establishing that the payment is not a concealed dividend is not enough to support allowance of compensation under this section. Even if it is not a concealed dividend, it is necessary that the amount be "reasonable" in relation to the service rendered.\textsuperscript{196} The problem of the tax adviser is to consider first how much can be or should be paid as compensation, and second, whether any alternative or supplemental ar-

\textsuperscript{193} Reg. \$ 1.248-1(c). The corporation must list the expenses and state when the expenses were incurred, when the corporation commenced business and the desired period over which the expenses are to be amortized.

\textsuperscript{194} See note 145, \textit{supra}.

\textsuperscript{195} \$ 162(a)(1).

\textsuperscript{196} Reg. \$ 1.162-7.
What is reasonable? Assuming that it is desirable to pay a high
rate of direct compensation, the first consideration is the going rate in
the industry, if figures are available. In theory, reasonable compensation
is viewed in the light of the compensation which the same executives
might have commanded if employed by an unrelated company in the
same or a similar business, and by the amount which the taxpayer com-
pany might have to pay if it were necessary to replace them. Such in-
formation is often within the general knowledge of the officers them-
selves or of their accountants or counsel. Occasionally, information of
this kind can be obtained by discreet inquiries of trade associations.

This does not mean that compensation must be limited strictly to
the average rate in the industry. If the going rate for a given position,
for example, is $20,000, a salary of $22,000 is hardly likely to invite
attack. Moreover, it is quite possible that where compensation has been
gradually increased over a period of years, it will not be reduced by the
Service in the first year in which it exceeds the Service's view of a
reasonable figure, and the tax saving for two or three years may justify
the loss occurring in a later year. At the same time, it must be remem-
bered that if compensation is stretched too far, the deduction may be
reduced below what otherwise might have escaped attack. Moreover,
the disallowance results in a true double tax; the deduction is disallowed
in the corporation's return, but the employee is nevertheless taxable on
the full amount. This risk, in the case of very large salaries, may be a
serious one. If a salary of $75,000 is paid and subsequently, after litiga-
tion, is reduced to $50,000, four or five years of excess payments may be
at stake before the matter is finally concluded. The company may in this
case have to pay the tax on an increase in its net income of $100,000
or more, but it does not have the $100,000, which has already been
distributed to the executive. Nor can the executive lend the money to
the company, because he has already spent most of it in high-bracket
income taxes.

If the risk of unreasonable compensation is to be assumed, precau-
tions may be taken to prepare in advance for litigation by creating a
favorable set of circumstances, at least eliminating some of the arguments
the Service might make. One important step in this direction is to
review the salary schedule for the nonstockholders. For example, if the
son of the sole stockholder earns more than does an unrelated person
performing similar services, the unfavorable attention of the examining
agent may be invited. Increasing the salary of the nonstockholder may be
less expensive than the disallowance of the son's salary.
The dividend policy of the company should also be considered. While the payment of reasonable dividends does not affirmatively support the salary allowance, the Service’s position is much stronger if only nominal dividends have been paid.

The same principle applies to director action. The fact that the directors have approved the compensation provides little affirmative support, but the absence of director action is a negative factor.\[197\]

Of course it should be emphasized that no arrangement should be permitted in which compensation is apportioned in accordance with stockholdings where there is any risk of disallowance.

Frequently salaries are set at an unreasonably low level and year-end bonuses are paid after those in control have been able to look over the year’s operations. It is quite easy for the agent to contend in such a case that a bonus, being paid only because the corporation had a substantial profit, is in effect a distribution of that profit, rather than a salary. This is particularly true where bonuses paid are in proportion to stockholdings. Where the financial problems of the business, on the other hand, require that the company refrain from committing itself to as much as is reasonable until it can determine that the funds are available, it is preferable to establish the right to the bonus at the beginning of the year. This can be done either by establishing that a bonus of a specified dollar amount is to be paid if funds are available, or by adopting a contingent compensation plan.

Contingent compensation. In general, contingent compensation will sustain a larger allowance in peak years than will ordinary compensation. It is unwise to rely too heavily on the implication in the regulation\[198\] that if the contingent compensation arrangement is reasonable when entered into, it will be sustained where changing circumstances result in higher compensation than was anticipated. This situation has arisen in times of rapid expansion of small businesses which unfortunately have coincided with excess profits taxes. At such times disallowances have been sustained in the face of long-existing plans in situations\[199\] where the executive, being in control, could have amended the arrangement when it began to generate an excessive salary for himself. This makes the contingent compensation arrangement somewhat less attractive in that the executive bears the burden of it in bad years but loses the advantage in good years.


199. E.g. Consolidated Apparel Co., 17 T.C. 1570 (1952), aff’d, 207 F.2d 580 (7th Cir. 1953); Hawaiian Freight Forwarders, 6 CCH Tax Ct. Mem. 601 (1947).
In any event, contingent compensation arrangements should be set as early as possible. Moreover, as in the case of straight salary arrangements, it is advantageous to have other employees compensated under comparable arrangements.

Contingent compensation may be combined with straight salary in a manner which may be quite effective where the executive performs several functions. For example, where the principal stockholder not only performs the functions of the administrative head of the organization, but is also responsible for a large part of its sales, which is often the case, he may be paid a reasonable salary for performing his administrative functions, and may also receive a commission on the sales for which he is responsible. If other salesmen or manufacturers’ agents are being paid commissions at the same rate on the sales for which they are responsible, it is sometimes found that the combination permits payment of total compensation which would be quite difficult to disallow.

**Illusory tax savings.** In the case of a high-bracket executive, consideration should be given to whether taxes are really saved by large salaries. Too often it is assumed that the reduction in the corporate tax is an automatic advantage. While this is true if the same amount would otherwise be paid out as a dividend to the same person, such a dividend may not have to be paid. If there are opportunities for expansion of the business, or if the $100,000 credit against unreasonable accumulations of income has not been exhausted, funds may be accumulated in the corporation, and the resulting increase in value may subsequently be realized upon the ultimate sale of the business. It is also possible that stock may be in trusts or in the hands of low-bracket members of the executive’s family, so that a dividend even though not deductible by the corporation, may yield a greater amount, after taxes, for the family. In this connection, see the prior discussion on the use of different classes of stock.

2. **The “Payment” Problem**

Most corporations are on the accrual basis, while most employees are on the cash basis. If the corporation accrues salary during the year but does not actually pay it until later, the corporate tax is reduced, but the employee’s tax is not decreased. To prevent this situation from resulting in tax avoidance, the Code provides that in the case of employees who are within certain prohibited relationships to the corporation, the deduction is disallowed unless actual payment is made within 2½ months after the close of the taxable year. This is applicable where the em-

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200. § 535(c)(2) as amended by the Technical Amendments Act of 1958.
201. § 267(a)(2).
ployee owns, directly or indirectly more than 50 per cent in value of the outstanding stock.\textsuperscript{202} The attribution rules apply, so that the 50 per cent includes stock owned by members of the family and related corporations, trusts, estates and partners.\textsuperscript{203} Where business necessity prevents payment within the prescribed period, the Code should be consulted and the facts examined to be sure that the prohibited relationships do not exist. Denial of the deduction under this rule loses the deduction forever (even upon subsequent actual payment) and where the prohibited relationship exists, it is preferable either to reduce the salary payable or to have the employee take it into income by receiving actual payment and making subsequent advances to the company if necessary.

\textit{Designation of payments.} Where it is important that compensation be considered paid within the prescribed period, it is important that payments be specifically so designated where any other amounts may be owing, such as unpaid compensation for prior years. In the absence of such designation, the payment has been applied to the earlier debt.\textsuperscript{204}

\textit{Use of notes.} Notes issued as compensation are deductible by the corporation to the extent of their fair market value, and includible by the employee to the same extent.\textsuperscript{205} Where the employee has returned the notes at their face amount, it seems unlikely that disallowance of deduction of the same face amount would be attempted or would succeed except in extreme circumstances. The notes need not be demand notes nor need they be payable before the expiration of the 2\(\frac{1}{2}\) month period,\textsuperscript{206} but it is probable that a long maturity would result in an attack on the fair market value, particularly where the interest rate is low. It seems advisable to use short-term negotiable notes bearing a reasonable amount of interest.

It should be noted that the possibility that the notes may become worthless presents a tax risk for the employee. Even though the notes are received and reported in income as compensation, the loss which the employee suffers if they are not paid has been held to be a non-business bad debt and hence deductible only as a short-term capital loss.\textsuperscript{207}

3. \textit{Special Problems of Employee Compensation}.\textsuperscript{208}

\textit{Qualified pension and profit-sharing plans.} Pension and profit-sharing plans are among the most common means of providing benefits to

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\begin{enumerate}
\item 202. \textit{§} 267(b) (2).
\item 203. \textit{§} 267(c).
\item 204. Lincoln Storage Warehouses v. Commissioner, 189 F.2d 337 (3rd Cir. 1950).
\item 205. Reg. \textit{§} 1.267(a)-1(b) (3).
\item 208. For a general discussion of methods of executive compensation other than
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employees (including executives) which provide compensation without incurring present tax burdens. The tax incidents of such plans are governed by extensive provisions of the Internal Revenue Code and regulations, and their preparation and operation constitute a subject as extensive and complex as any subject in the field of taxation. It will be possible here only to provide a very brief explanation of their general nature and what they may be expected to accomplish.\footnote{209}

A pension plan is a plan of deferred compensation under which the employer undertakes to set aside specified amounts in order to provide pensions upon retirement. The amounts to be set aside are dependent upon such factors as the number of persons employed, the age of the employee (as bearing on the number of years remaining until he reaches the proposed retirement age) and the period of time in which he has been employed by the company. From such data the amounts to be contributed are determined by actuarial methods, in order that, if the required amounts are contributed each year, it may be anticipated that the necessary funds will thus be provided to pay the pension which the employer is committed to provide under the plan.

A profit-sharing plan, on the other hand, as the name implies, is a plan of deferred compensation in which the amount set aside by the employer is measured by profit. There is no commitment in advance as to the amounts which the employees will receive upon retirement, since that is dependent upon earnings.

The tax advantage of these plans is that, if they are properly drawn and administered so as to comply with the requirements of the Code,\footnote{210} the contributions of the employer are deductible, but the employee is not taxed until he begins to receive benefits, an event which will presumably take place at a time when he is in a considerably lower income-tax bracket.

It is not enough that the employer set aside on its books funds for the future pensions or for future distributions of profits to its employees; it is necessary that they be paid, such as to a trust or to an insurance company. If a trust is used for a pension or profit-sharing plan, and if the trust qualifies under the Code, it is tax exempt, not only with


\footnote{210} \S\S 401-4.
respect to the amounts paid to it under the plan but also with respect to any earnings on its investments.211

In the case of a pension plan, it will at once be apparent that when such a plan is established, some of the employees may be considerably nearer to the retirement age than others, and some will have been employed for a considerably longer time than others. The plan usually provides for a pension which takes into account length of service as well as compensation received. The result is that in order to pay the desired pensions, it is necessary to contribute an amount representing past services. This amount is referred to as the "unfunded cost of past service credits." This amount may be paid currently or may be paid over a period of years, but the deduction is spread forward under the Code, so that it may not be deducted in its entirety in the first year.212

The plan may further provide for contributions by the employee as well as by the employer; the employee's own contribution being in effect exempted from the tax on its return to him. Where the entire distribution to the employee is made within a single taxable year on account of his death or the termination of his employment, the amount he receives in excess of his own contributions is treated as a long-term capital gain. The portion representing his own contribution is not taxable.213 Where the distribution is not made in a lump sum, but is paid over a period of years, it is treated as an annuity and taxed in accordance with the provisions of the Code applicable to annuities.214 In general, this means that if the plan is a non-contributory plan, all of the amounts received constitute ordinary income. Where the employee has contributed to the plan, the amount of his contribution is considered as the cost of the annuity to him. With respect to annuities generally, the taxable income each year is determined by spreading the consideration paid over the anticipated period during which payments are to be made, the excess being ordinary income, except that where an amount exceeding the employee's entire contribution is payable during the first three years, the employee first recovers his own contribution tax free, thereafter paying ordinary income tax on the balance.

In addition to the foregoing advantages, these plans have the additional advantage that the amount payable to a beneficiary after the employee's death is not subject to estate tax except to the extent that it is attributable to the employee's own contributions.215

211. § 501(a).
212. §§ 404(a) (1) (B), 404(a) (1) (C).
213. § 402(a) (2).
214. § 72.
215. § 2039(c). See Gewanter, Rights of Employees and Their Widows and Heirs under Qualified Section 401(a) Plans: Estate and Gift Tax Consequences, N.Y.U. 16th INST. ON FED. TAX 57 (1958).
All of these advantages depend upon the qualification of the plan under the provisions of the Code, which provides in general that the trust be exclusively for the benefit of the employees and that it shall not be discriminatory. The remainder of the requirements are largely refinements on these basic principles. Thus it must be impossible, before all employees and beneficiaries have received their benefits in full, for any part of the corpus or income to be diverted to any other purpose. With respect to the matter of discrimination, it is not necessary that all employees be covered under the plan or even that all employees be eligible. Although the contributions and the benefits under the plan may not discriminate in favor of officers, shareholders, executives, or highly compensated employees, the plan itself may, if desired, exclude hourly rated employees or be limited to salaried or clerical employees. It is the uniform practice to obtain in advance a ruling with respect to any such plan, as the contributions will be deductible only if the plan qualifies.

The Code also provides limits on the amounts which may be deducted. In the case of a pension plan, the deductible contributions of the employer may not exceed 5 per cent of the aggregate compensation of the covered employees, plus an additional amount necessary to fund the past service credits, distributed over the calculated remaining future service of each employee. Instead of this formula, the contribution may be limited to an amount equal to the “normal cost” of the plan, which is the amount which would be required if the plan had been in effect from the beginning of service of each included employee plus 10 per cent of the past service credit unfunded at the time the employee qualified.

In the case of a profit-sharing plan a different formula is applicable, since the contribution is not determined by the necessity of providing any specified amount of pension. In this case the amount which may be deducted in any one year is limited to 15 per cent of the compensation otherwise paid or accrued to the participating employees. Where the amount actually contributed is less than this limit, the balance may be carried forward to a later year and deducted in that year in an amount not in excess of an additional 15 per cent of the compensation for the later year. On the other hand, if the amounts paid in one year are greater than the amount deductible, the excess may be carried forward and deducted in a later year in which there may be a deficiency.

Other deferred compensation arrangements. The foregoing discussion relates, of course, only to qualified plans. It is also possible to defer compensation under a plan which is not intended to qualify under the

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216. § 401.
217. § 404.
Code, as, for example, a plan which does not pretend to be nondiscriminatory.\(^{218}\) While many of the tax advantages are of course lost if the plan does not qualify, nonqualified plans are nevertheless frequently adopted, where the advantage of being able to provide deferred compensation for one or two executives outweighs the tax advantage of a qualified plan. The general rule applicable with respect to a nonqualified plan is that if the employee's rights are nonforfeitable when the employer makes its contribution, the employer may deduct the contribution\(^ {219}\) and the employee is taxed at the same time.\(^ {220}\) Since the employee has to pay his tax currently, such a plan might be more properly entitled "withheld compensation," and the employee might just as well have been paid currently. However, if the employee's right to the payment is forfeitable, the employee is taxable only at the time when it is paid to him, even though it becomes nonforfeitable at an intervening date,\(^ {221}\) but the employer's deduction is lost.\(^ {222}\) When the plan is not funded, as where there is merely a commitment to pay a pension at a future date, the actual payment is deductible, being nonforfeitable at that time. It seems reasonable to suppose that under a nonfunded plan there would be no possibility of income to the employee whether his rights are forfeitable or not, since no taxable event has occurred. However, in view of the possible risk that the firm obligation of the employer to make a future payment to the employee might itself be considered property so as to constitute income to the employee at the time the obligation arose, it has become the general practice to make the employee's rights contingent on continued employment until retirement and noncompetition thereafter. In such instance both the receipt of income and the accruing of the deduction will be deferred until actual payment.

**Stock options.** The stock option is another useful incentive device.\(^ {223}\) The advantage in such a plan is that the employee may be given currently a right to subscribe for stock in the company at its present value, but need not actually buy it until a later date when his efforts have presumably caused it to increase in value. Such plans were in common use at one time until the development of the rule that the employee realized income, by way of compensation, to the extent of the value of his bar-

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219. § 404(a) (5).
220. § 402(b).
221. Reg. § 1.402(b)-1.
222. § 404(a) (5).
gain at the time it was exercised. Subsequently the Code was amended to permit the use of stock options provided that prescribed qualifications are met, and options meeting the test (referred to as "restricted stock options") avoid this penalty. The principal objective of the statutory requirements for restricted stock options is to insure that the option price is approximately the value of the stock at the time the option is first granted to the employee, and to insure that the employee actually holds the option or the stock or both for a reasonable length of time.

With respect to the option price, two standards are established. One applies where the price is at least 95 per cent of the fair market value and the other where the price is at least 85 per cent but not more than 95 per cent. The difference between the 85 per cent and 95 per cent options arises only upon disposition of the stock by the employee or upon his death if he still owns the share. In the 85 per cent case, the employee realizes ordinary income to the extent of the difference between the option price and the value of the stock when the option was granted or when it was exercised, which ever is less. In other words, if the option price was exactly 85 per cent, the employee is taxable on the remaining 15 per cent when he disposes of the stock, but that part of his profit arising from any increase in value of the stock after he obtained the option is not taxable except as capital gain upon sale. In the 95 per cent case, the entire gain is taxable only as capital gain on sale of the stock.

A special rule is applicable in the case of employees having more than 10 per cent of the voting power of the corporation, taking into account attribution of stock owned by family members. As to such employees, the option price must be 110 per cent of the value at the time of the grant in order to be a restricted stock option at all.

In any event, for maximum tax advantage the option must be exercised during the period of employment or within three months thereafter, and the stock may not be sold less than two years after the grant of the option or six months after the issuance of the stock, whichever is later. In the case of the 10 per cent stockholder, it is also required that the option must not be exercisable after five years.

The stock option is a valuable aid in assisting executives to acquire an interest in the company. The principal problem in the case of the closely held corporation lies in determining the value of the stock, particularly as this is a factual question upon which the Treasury will not rule.


225. § 421.
Where there are inter-stockholder agreements for the purchase and sale of stock upon retirement or death, it seems probable that such arrangements if agreed to at arm's length between unrelated parties, and if they are binding at all events (and not merely upon death) will probably be respected as fixing the value of the stock. In the absence of such arrangements, appraisals by qualified outsiders or other evidence of an intent to fix an actual value in good faith would be advisable, although risk of attack on the valuation can never be entirely avoided. In any event it would be unwise in any close corporation to determine the value and set the option price at 85 per cent or 95 per cent of that figure. It is always advisable to use at least 100 per cent as the option price and thus have a 5 per cent or 15 per cent margin for error.

Stock bonus plans. Another method of producing employee stock ownership is through a stock bonus plan. Such a plan may be a qualified stock bonus plan, like a qualified pension or profit-sharing plan, or it may be simply the grant of stock directly to the employee. A qualified plan is governed in general by the provisions applicable to profit-sharing plans, being a deferred compensation arrangement. It should be noted that it has one advantage not present in the ordinary pension or profit-sharing plan in that the contribution does not involve any actual cash payment.

Instead of establishing a qualified plan, the stock may be issued directly to the employee, who is of course taxable on its value. It is often the practice to combine the stock bonus with a cash bonus sufficient to pay the employee's additional income tax. There is still an advantage over the bonus paid entirely in cash, of course, in that the employer can deduct the fair market value of the stock.

Other arrangements providing fringe benefits. In arranging compensation, consideration should also be given to various fringe benefits which may provide direct or indirect advantages which are not taxable. A plan for continuation of compensation in case of illness or accident permits the employee to exclude from his income his compensation for the period of his absence from work up to $100 a week, with a one week waiting period in cases other than sickness requiring hospitalization or personal injury. Accident and health plans may be adopted to provide

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226. §§ 401, 402, 404.
227. I.T. 1197, I-1 CUM. BULL. 269 (1922).
228. See Bailey, Compensation with the Fringe on Top, N.Y.U. 16TH INST. ON FED. TAX 75 (1958).
229. § 105(d). Payments for the first week of absence are not excludible except in case of personal injury or of illness requiring hospitalization.
reimbursement for medical expense and such payments are nontaxable to the employee although the cost is deductible.230

One fringe benefit on which a warning should be sounded is the expense account. Under current regulations,231 where the employee receives an expense account as contrasted with specific reimbursement of expenses, he is required to account for the actual expenses incurred and to include the excess in income. It is possible, whichever method is used, to pay for entirely proper expenses, which nevertheless result in some benefit to the employee, such as legitimate entertainment expenses, club dues, etc. to the extent that such payments are proper business expenses. Abuse, however, is apt to result in substantial disallowances, and even in fraud charges, and over-reaching is dangerous.

Death benefits to the employee's family are an additional fringe benefit which may be of real dollar value to the employee. Such plans are discussed below.

C. INSURANCE PROGRAMS

Without question there are legitimate corporate objectives to be accomplished by corporations in carrying insurance on the lives of their executives. Such insurance is a means of providing funds for pensions and other deferred compensation arrangements and obligations, for death payments to widows, and for carrying into effect stock buy-out programs. Those are all purposes which benefit the corporation. Typically, however, in the case of the small and closely-held corporations, the corporate executive on whose life the insurance is carried is also a shareholder, and since insurance carried by the corporation for any of the above purposes also serves to benefit him or his beneficiaries, it is frequently difficult to segregate the corporate from the personal purposes served by the insurance. It is that difficulty which sometimes causes trouble in the application of the income tax rules regarding life insurance in the corporate field.

Generally speaking, those income tax rules are well-defined and easily understood. Thus, a corporation may not deduct,232 and the insured employee is not taxable on,233 the amount of any premium paid by the corporation on any life insurance policy covering the life of an officer

230. § 105(b).
232. § 264(a)(1). Note also that although interest paid on indebtedness is normally a deductible item (§ 163(a)), interest paid on indebtedness incurred to purchase a single premium life insurance, endowment or annuity contract is non-deductible. § 264(a)(2); Reg. § 1-264-2.
233. See O.D. 627, 3 CUM. BULL. 104 (1920).
or employee if the corporation is directly or indirectly the beneficiary under the policy. If, however, the employee is permitted to name the beneficiary of the policy, or if, in fact, the corporation names as the beneficiary the employee’s wife or other dependents or his estate, the amount of the premiums constitute taxable income to the employee.234 Also, the proceeds of life insurance contracts are not includible in gross income if such proceeds are paid by reason of the death of the insured.235

The real difficulty lies, however, in the application of the general rules to cases in which the corporation is the owner of the policy and is named as the beneficiary, but the proceeds are nevertheless earmarked under a stock purchase or pension agreement for payment to the insured employee-shareholder or his beneficiaries. In several recent cases, the Commissioner has contended, and the lower courts have concurred, that the employee-shareholder whose life is insured is the real beneficiary of the policy under such circumstances and that such employee-shareholder, therefore, is taxable on the amount of the premium under the foregoing stated rules. Each case has been reversed, however, by the appellate courts on appeal.236 Despite this solid front at the Court of Appeals level, it would seem wise for the draftsman of stock purchase and pension agreements to avoid, to the extent possible, the earmarking in the agreements of insurance proceeds to meet the obligations created by the agreements. If the insurance is carried by the corporation without specific earmarking of the proceeds it is extremely doubtful whether, in the light of the general rules stated above, the Commissioner would claim that the insured employee-shareholder was the real beneficiary of the policy.

D. Guarding Against Unexpected Income to Shareholders

The problem of unexpected income (and the unexpected disallowance of deductions) is of particular importance in small closely held corpora-

234. Reg. § 1.61-2(d) (2); G.C.M. 8432, IX-2 CUM. BULL. 114. If it can be established that the carrying of the insurance was intended as additional compensation, the amount of the premiums constitutes a deductible expense to the corporation. G.C.M. 8432, IX-2 CUM. BULL. 114. Deductibility as compensation is always subject to the tests of reasonableness and whether in fact paid purely for services. Ibid. and Reg. § 1.162-7. Premiums paid by a corporation on group term life insurance for its employees constitute an exception to the general rule. The amount of such premium is not taxable to the employees even though the employees designate their beneficiaries.

235. § 101(a).

tions where transactions between the corporation and its shareholders are subject to close scrutiny, if not to say suspicion, and where it is difficult to separate shareholder from corporate motives and purposes. The problems are difficult to categorize because they are so varied. They may arise, for example, in the sale of property by a shareholder to the corporation, and in the sale of property by the corporation to the shareholder; in cases of interest-free loans to shareholders or loans to shareholders which are outstanding and inactive for substantial periods; and in cases of cancellation by the corporation of the indebtedness of a shareholder. Similarly, a shareholder receiving repayment of a "loan" to the corporation may find that, instead, he has received a constructive dividend, and the corporation paying "interest" on such "indebtedness" may be denied an interest deduction on the grounds that a true indebtedness did not exist. The problems may, and perhaps more frequently do arise in the field of stock transactions. But there are equally as many pitfalls to the unwary or reckless shareholder in the field of "expense" payments by a corporation where such payments benefit a shareholder directly or indirectly.

The tax consultant must be constantly on the alert, in his analysis of any transaction coming to his attention which is between a corporation and related persons or entities, to guard against the possibility of unex-

237. If the price paid by the corporation is excessive, or inadequate, the excess over fair market value, or the amount by which the fair market value exceeds such price, as the case may be, may be treated as a dividend to the shareholder. Reg. § 1.301-1(j). In either case, if the property involved is depreciable property and if the shareholder, his spouse, minor children and minor grandchildren own more than 80% of the corporation's stock, the gain, if any, on the sale will be treated as ordinary income to the transferor. § 1239.

238. See discussion and cases cited in 2 CCH 1958 STAND. FED. TAX REP. § 2377.654.

239. Amount of cancelled debt treated as a distribution of property. Reg. § 1.301-1(m).


242. Examples are: sale of stock to issuing corporation (§ 317(b)), sale of stock to sister or subsidiary corporation (§ 304), sale or redemption of "tainted" or "hot" stock (§ 306), sale or exchange of stock of a collapsible corporation (§ 341(a)), taxable stock dividends (§ 305(b)), "boot" on recapitalization exchanges (§ 356(a)(2)) and distributions made when there is outstanding a loan to the corporation which was made, guaranteed or insured by the U.S. or any agency thereof (§ 312(j)).

243. Payment by corporation of shareholder's "personal" expenses is an example. See Greenspon v. Commissioner, 229 F.2d 947, 853-56 (8th Cir. 1956). Result, of course, may be two-fold in that corporation may be denied the deduction and the shareholder treated as having received taxable income.
pected taxable income (or unexpected denial of a deduction). Careful step by step planning is important. False steps, occasioned by "spur of the moment" action, are dangerous. Close scrutiny by an examining agent should be anticipated in all transactions between the corporation and its shareholder-officers and persons or other entities related to them. In all cases, an honest effort should be made to make the terms the equivalent to those which would prevail in an arms-length transaction. If valuation is important, the values should, in appropriate cases, be based upon independent appraisals made prior to the transaction. Clear written records should be made and maintained and the transactions should be accorded the same legal consideration and treatment (e.g. written leases, bills of sale, etc.) as would be the case if strangers were involved. Once the terms of the transaction are set, they should be honored, as a departure may give rise to an inference of sham or bad faith.

E. Financing the Going Concern

We have noted three basic routes by which a new corporation is financed: loans (including deferred payment sales), licenses (or leases), and contributions (of cash or of property). The financing of a going concern also requires a selection of one or more of these three basic routes. Most of the considerations which affect the choice in the case of a new corporation are also relevant in the case of an established one.244 There are, however, some additional factors which are considered here.

1. Loans

We have already noted the uncertainty of the law applicable to classification of stockholder loans made at the time of incorporation, as to whether they constitute genuine debt or equity investment. The difficulties are frequently even greater where the financing takes place after the corporation is established. The additional complications stem from the additional evidence, frequently conflicting, which is likely to be present. By now the corporation will have a corporate history. It will have a credit rating; it will have honored its obligations punctually, or it will have failed to meet them; it will have been regarded as credit-worthy by third persons dealing at arms-length, or it will not; it will have profits, or losses; it will have paid dividends, or it will not. Further, the values of its assets will have changed, possibly in ways which are difficult to measure. It is clear that it is the fair market value of the

244. See pp. 19, 21 and 25, supra.
Yet the book surplus cannot be ignored, for it will at least call attention to, or divert it from, the true financial position of the business.

The circumstances which the courts have regarded as relevant to distinguishing debt from stock have already been discussed and it will be helpful only to add here a few practical suggestions on the handling of post-corporation financing. The selection of a method of financing need not be resolved on an all or nothing basis. Where a proposed loan would make an outstanding debt appear dangerously large in proportion to the then fair market value of the equity, the funds can be advanced partly for debt and partly for preferred or common stock. The risk of serious tax consequences can be mitigated by establishing tiers of debt, and providing for smaller principal payments in earlier years than in the later years after the character of the debt has been established. Finally, it should be remembered that new money should not be advanced to a close corporation as equity, without considering whether it would not be more prudent to contribute to capital some of the existing debt of the corporation, the genuine indebtedness status of which may be doubtful, so that the new funds may be invested for a debt instrument the status of which is beyond question. Where this plan is followed, it is advisable that the new indebtedness be distinguished from the old by real differences in its terms.

2. Licenses

We have already seen that the shareholders of a new corporation may find it more advantageous to own some of the assets of the business themselves (or place them in a sister corporation) and lease or license them to the corporation, than for the corporation to own all of the assets of the business. These same considerations are, of course, applicable where a going concern requires additional properties. So long as assets which are new to the business are involved, it is never too late for a corporation to adopt the policy of leasing or licensing business assets from a shareholder, a group of shareholders, a partnership composed of shareholders, a corporation owned by shareholders, or a family or charitable trust. It is necessary only that, where related parties are involved, the rent or royalty be fair, the lease or license be "genuine," and the requirement that expense and rental obligations accrued by an accrual basis tax-
payers and owing to a related cash basis taxpayer be promptly paid. These matters are discussed below.

Sale and lease-back. Where a going concern requires cash, the sale and lease-back of property is a means of financing not to be overlooked. Of course, it has its price: title to the property at the end of the period will remain with the financing agency. Particularly in an inflationary period this price is not inconsiderable. Frequently, however, a sale and lease-back yields more immediate funds than a mortgage, for a purchaser is generally willing to pay more than a mortgagee. As we have pointed out above, leasing property is less likely to create a thin capitalization risk than a stockholder loan; the obligation of a lease or license is generally reflected in the footnote of a balance sheet, if at all, and there is (at least as yet) no authority that such an obligation should on a ground analogous to thin capitalization be regarded as the equivalent of stock. Finally, a sale and lease-back may yield direct tax savings. The sale of the property may produce a loss resulting in a carry-back; the sale of appreciated property may permit the purchaser a higher depreciation base to be obtained by payment of a capital gains tax by the seller; a lease to a charitable or loss corporation may result in deductions to the taxpayer corporation with no corresponding income to any other entity.

It is usually true in tax matters that where there are inherent tax advantages there are also inherent tax risks. Sales and lease-backs are no exception. Thus, where real estate is sold and leased back for a term of thirty years or more, the regulations provide that the transaction is an exchange of like properties on which no loss is allowed. Elaborate rules have been promulgated demarking the fine line which in the view of the Revenue Service separates a conditional sale of personal property from a lease with an option to purchase. Any lease of real or personal property which lasts so long that the lessor's reversion has no substantial value, or which is accompanied by an option which from the outset will almost certainly result in title reverting to the lessee, is likely to be treated

248. General discussions of financing by sale and lease-back may be found in Cary, Corporate Financing through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations, 62 HARV. L. REV. 1 (1948); Cohen, Transfers and Lease-backs to Trusts: Tax and Planning Considerations, 43 VA. L. REV. 31 (1957).

249. But see note 52 supra.


for tax purposes as what the Service thinks it in substance is, and not as what the taxpayer has in form made it appear to be.

Transactions between related parties. The risks are naturally enhanced whenever the transaction takes place between related parties. A sale to and lease-back from certain types of charitable organizations, under which the consideration is inadequate or which is regarded as a loan with an inadequate security or interest rate, may constitute a prohibited transaction forfeiting the exempt status of the charity.\(253\) Losses on sales between an individual and a controlled corporation or between two controlled corporations or between certain other related persons, are disallowed.\(254\) What would otherwise be capital gain on a sale of depreciable property becomes ordinary income if the parties are an individual and a controlled corporation.\(255\) And the requirement that certain accruals be promptly paid and that rents and royalties and prices be fair must be rigorously observed.\(256\)

In addition to skirting these statutory pitfalls, a lease or license between related parties must be designed so as to avoid an attack on its genuineness. As in the case of the attempts of the Revenue Service and the courts to classify loans as genuine debt or as capital, it is impossible to set out precisely the circumstances which will lead a lease or a license to be disregarded because, as the courts put it, it is “without substance and effect for tax purposes.” On two occasions the Tax Court has held, in decisions affirmed by two courts of appeal, that what purported to be rentals paid by a corporation to its shareholders were to be treated as dividends.\(257\) In one case the “lessor” was a principal shareholder married to the other principal shareholder. In the other, the “lessor” was a partnership whose equal partners were the stockholders of the corporation, whose holdings of stock, however, were distinctly unequal. In each case, the “lessor” borrowed from a bank the funds with which to purchase the “leased” property from the corporation, and in each case the Tax Court found that the bank had relied on the solvency of the corporation as an assurance of payment.

Despite these threatening decisions, it is clear that many leases from shareholders to their corporation are respected for tax purposes.\(258\) While

\(253\). § 503(c).
\(254\). § 267(a) (1).
\(255\). § 267(a) (2). See also § 482, authorizing the Commissioner to reallocate income and deductions among businesses controlled directly or indirectly by the same interests, where necessary clearly to reflect income.

\(256\). Stearns Magnetic Mfg. Co. v. Commissioner, 208 F.2d 849 (7th Cir. 1954).

\(257\). Catherine G. Armstrong, 12 T.C. 539 (1949), aff’d, 188 F.2d 531 (5th Cir. 1951); Shaffer Terminals, Inc., 16 T.C. 356 (1951), aff’d per cur. 194 F.2d 539 (9th Cir. 1952).

\(258\). Department of the Treasury, Internal Revenue Service, Revenue Ruling 64–148, 1964–1 C.B. 236. See also § 482, authorizing the Commissioner to reallocate income and deductions among businesses controlled directly or indirectly by the same interests, where necessary clearly to reflect income.
TAX PROBLEMS OF CLOSE CORPORATIONS

a sale and lease-back between related parties is obviously vulnerable, it can be respected if there are sufficient circumstances attesting its genuineness. A reason for the transaction, other than the avoidance of tax, is helpful, as is the avoidance of unorthodox provisions in the contract and administrative arrangements which give the ostensible lessor less control over the property than lessors usually demand. It is important that there be at least a partial dissimilarity of interest between the lessor and lessee, although it is neither sufficient nor essential. Perhaps all that can be ventured as a general rule is that an arrangement, entered into for a business purpose, of a kind which might reasonably be expected between persons dealing at arms-length, which is on orthodox terms, and the terms of which are lived up to, should be respected for tax purposes even though it yields substantial tax advantages to the parties.

3. Contributions and Transfers

One of the reasons, we have seen, for keeping as much property as possible out of a corporation when it is first established is that the decision can always be reversed, and the property contributed later, while a converse change of heart is frequently possible only at prohibitive tax cost. As in the case of transfer of shareholders' property to a new corporation, there are a number of ways shareholders can put assets into an established one. Occasionally, a taxable sale is desirable, where it yields a tax loss, or an advantageous higher basis, or an opportunity to "thin" the equity. More often, a tax-free transfer is preferable, in which the tax basis to the shareholders carries over to the corporation. The considerations which influence the choice between these methods, and the precautions which must be observed in employing them, have already been discussed in the context of a new corporation; and since they do not differ materially when the corporation is mature, they are not repeated in full here.

Once the corporation is out of its infancy, a capital contribution is a common practice, where the property or cash to be contributed is owned by the shareholders in proportion to their common stock positions. Where this is not the case, the possibility that the contribution will in part be regarded as a gift or as compensation taxable to other shareholders must be watched; and where the disproportion is very great, attack on the ground that the contribution was not made "by a shareholder as such" should be anticipated. Despite these hazards, a shareholder does some-

259. See p. 19, supra.
260. A capital contribution has the advantage of administrative simplicity, and avoids issue taxes, possible shareholder action to increase authorized capital, and blue sky formalities.
261. Under § 362(c) (1) (B), the consequence is that basis will be zero.
times make a non-pro rata contribution to a corporation for the purpose of increasing the equity, and where he does so there has been no exchange and no other taxable event. However, an important disadvantage of a capital contribution in many circumstances is that an increase in stock basis attributable to a capital contribution is not eligible for small business corporation stock ordinary loss treatment under the new provisions of the Code.

Where a tax-free transfer to a mature corporation is attempted in consideration of stock or securities, the primary requirement to be met is "control" of the corporation immediately after the exchange by the transferors. "Control" is defined to be "ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation." Thus, where senior financing has been obtained by non-voting preferred stock owned, for instance, by older members of the family, the active younger common stockholders may not be able to arrange a tax-free transfer of property owned by them to the corporation, for they will not own 80 per cent of the preferred class. The grant of a modest voting power to the preferred stockholders might have eliminated this objection; and the voting power can if necessary be extended to the preferred at the time of the desired transfer. Alternatively, a capital contribution might be made. In this situation, or any other in which the property to be transferred is owned by less than the controlling group of shareholders, the non-property-owning shareholders may be included in the "one or more persons" who made "the exchange" by having them transfer for stock a material amount of cash or other property (but not services) in the exchange.

We have considered the case where the property to be transferred is owned by less than all of the stockholders. Trouble also arises where it is partly owned by persons who are not desired as stockholders, or at least as voting stockholders. This problem, too, is frequently curable, for the requirement that the consideration be "stock or securities" does not mean that all of the transferors must get voting stock, or stock of any description, in proportion to their respective interests in the transferred

263. § 1244(d) (1) (B), added by Small Business Tax Revision Act of 1958, § 202(b). See p. 30, supra, for discussion of this important new provision.
264. For a more complete discussion of the pertinent Code provision, § 351, see p. 19, supra.
265. § 368(c).
266. But see Reg. § 1.351-1(a) (1) (ii).
property. Prudence dictates that each transferor desiring to qualify for wholly or partially tax-free treatment get a material stock interest, and that at least a majority in interest in the property be held by persons who individually after the transfer own 80 per cent of the corporation's common stock; but if these two basic ideas of some continued equity interest for all the transferors, and a rough continuity of controlling interest, are met, effective control can be retained by a group which excludes a minority of the owners of the transferred property.\textsuperscript{267}

\section*{F. Guarding Against Unexpected Personal Holding Company Status}

As will be seen, the closely held corporation is particularly vulnerable to the statutes relating to the imposition of the personal holding company surtax because it will probably find that it satisfies the stock ownership test, which, when met along with a second test, subjects the corporation to the personal holding surtax on its undistributed personal holding company income\textsuperscript{268} at rates as high as 85%.\textsuperscript{269}

With certain exceptions\textsuperscript{270} any corporation more than 50% of whose stock, during the last half of the taxable year of the corporation, is owned\textsuperscript{271} directly or indirectly, by or for five or fewer individuals and at least 80% of its gross income is derived from specified sources\textsuperscript{272} is a personal holding company for that year.

Where the corporation can avoid being classified as a personal holding company because the control by shareholders is not within the above mentioned shareholder test, the type of corporate income is immaterial. However, once the shareholder test applies, the source of the gross income of the corporation and the amount thereof become vital factors to be considered. When examining the gross income of the corporation for

\textsuperscript{267} It is, however, possible that § 351 should be construed literally to require that each member of the group of "one or more persons" which transfers property in the transaction be included in the group of "such person or persons" which is in control immediately thereafter.

\textsuperscript{268} As defined in § 545. Note that types of income other than personal holding income are subject to the surtax once the statute applies. Proposed Reg. § 1.545-1 (a).

\textsuperscript{269} 75\% on the first $2,000 of undistributed personal holding company income and 85\% on the balance thereof. § 541. A corporation can reduce its surtax liability under specified rules covering deficiency dividends to its shareholders. § 547.

\textsuperscript{270} Insurance companies, surety companies, loan companies and others meeting the definitions appearing in § 542 (c).

\textsuperscript{271} Special attribution of ownership rules apply in determining ownership. § 544. Note that the shareholders of a parent corporation are deemed to own ratably the shares of a controlled subsidiary when applying the stock ownership rules. § 544(a) (1).

\textsuperscript{272} As set forth in § 543.
the purpose of determining the portion thereof that constitutes personal holding company income, it is important to recognize that gross income is not synonymous with gross receipts.\textsuperscript{273} The accounting practice of the taxpayer may have an important bearing on the determination of the amount of the gross income.\textsuperscript{274}

Where the corporate arrangement consists of a parent operating corporation\textsuperscript{275} and a subsidiary corporation whose gross income consists of personal holding company income, the subsidiary corporation will seldom be disregarded for personal holding company tax purposes even though no personal holding company problems would arise had the parent corporation received both the operating income and the personal holding company income.\textsuperscript{276} Further, such a subsidiary corporation may lose the benefit of the $25,000 surtax exemption.\textsuperscript{277} Where the corporate arrangement is reversed, the personal holding company problems are approximately the same though more apparent. Where the parent corporation in such an arrangement holds solely stock of the subsidiary, any dividend income which it receives, though taxed at a reduced rate,\textsuperscript{278} nonetheless constitutes personal holding company income which does not receive the benefit of the intercorporate dividend deduction in computing the surtax on undistributed personal holding company income.\textsuperscript{279}

The statute\textsuperscript{280} specifies the various types of income which are characterized as "personal holding company income." Personal service corpo-

\textsuperscript{273} Proposed Reg. § 1.542-2. Woodside Acres Inc. v. Commissioner, 134 F.2d 793 (2d Cir. 1943). \textit{Cf.} the approach to gross income under § 6501(e) in Reg. § 301.6501(e)-1(a)(ii). Also \textit{cf.} The Colony Inc. v. Commissioner, 244 F.2d 75 (6th Cir. 1957).

\textsuperscript{274} Gross receipts are reduced by direct operating expenses to determine gross income. Treatment of a portion of the depreciation as a deduction from gross income rather than as a direct operating expense may be helpful. See 3 CCH 1958 \textit{STAND. FED. TAX REP.} § 3329.006 for other related suggestions.

\textsuperscript{275} The gross income of which is other than personal holding company income as defined in § 543.

\textsuperscript{276} American Package Corp. v. Commissioner, 125 F.2d 413 (4th Cir. 1942). \textit{Cf.} Inland Development Co. v. Commissioner, 120 F.2d 986 (10th Cir. 1941). The separate entity of the subsidiary will not be disregarded even where the subsidiary derives personal holding company income solely from the parent corporation, and no tax benefit was derived from the dual operation. The Heater Corporation, 13 CCH Tax Ct. Mem. 867 (1954).

\textsuperscript{277} § 11(c).

\textsuperscript{278} If qualifying under § 243 for the 85\% dividend received deduction, the dividends are taxed at an effective rate of either 4.5\% or 7.8\%, depending upon the size of the taxable income. Where the only income of the corporation is dividend income, it can receive approximately $167,000 of dividend income at an effective normal tax rate of 4.5\% because of the dividends received deduction.

\textsuperscript{279} § 545(b)(3).

\textsuperscript{280} §543.
ocations such as the management type, manufacturers representatives, research and development organizations and advertising agencies receive the type income that may be classified as personal holding company income. Closely held real estate holding corporations are in danger of the imposition of the personal holding company surtax because all rentals constitute personal holding company income unless the rentals constitute 50% or more of the gross income. Rentals received from shareholders for the use of corporate property constitute personal holding company income. Where the shareholder so entitled to use the property owns, directly or indirectly, 25% of the stock of the corporation, the rental is personal holding company income but is not classified as rental for the purpose of applying the 50% rental exclusion rule when determining whether the corporation is a personal holding company. To relieve certain undue hardships in the case of leasing corporations, Congress has excluded rentals to shareholders from the definition of personal holding company income where not more than 10% of the gross income of the corporation consists of personal holding company income other than rentals.

A corporation in liquidation which otherwise was not in danger of being classified as a personal holding company may be so classified where it no longer has income from operations and the income that it does have constitutes personal holding company income. Liquidating distributions may qualify as deductions in determining the corporation’s

281. Where the nature of the service rendered falls within the definition set forth in § 543(a)(5).
282. § 543(a)(7). Reg. § 1.543-1(b)(10). It is the portion of the gross income of the corporation which consists of rentals that is so classified. Here again, the problem of gross receipts v. gross income is raised. See notes 273, 274, supra. Where the lessee has, for example, assumed the real estate taxes on the leased real estate, the lessor should increase gross receipts by the amount thereof and deduct the taxes from gross income. 5 CCH 1958 STAND. FED. TAX REP. § 3332.1314. This increases the gross income from rentals for the purpose of applying § 543(a)(7) and, depending upon the circumstances, may be beneficial to the corporation in applying the percentages under the statute.
283. §§ 543(a)(6) & (7). Hatried, Inc. v. Commissioner, 162 F.2d 628 (3rd Cir. 1947). Where the use of the property is by a partnership of which the shareholder is a member, the shareholder is considered the user of the property. Randolph Products Co. v. Manning, 176 F.2d 130 (3rd Cir. 1949). Walnut Street Company v. Glenn, 83 F.Supp. 945 (D.C. W.D. Ky. 1948). Where the use of the property is by a controlled lessee corporation, the use may be held to be that of the shareholder despite the separate corporate entity of the corporate lessee. 320 East 47th Street Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); but see Minnesota Mortuaries Inc., 4 T.C. 280 (1944), acq. 1945 CUM. BULL. 5.
284. § 543(a)(6). Reg. § 1.543-1(b)(9).
285. Lane-Wells Co., 43 B.T.A. 463 (1941).
286. For example, where the proceeds from the sale of operating assets are invested in stocks and bonds.
undistributed personal holding company income.\textsuperscript{287} Notwithstanding the classification as a personal holding company, it may be advantageous for a corporation that has sold its assets to remain in existence as a personal holding company, distributing its income yearly to shareholders.\textsuperscript{288}

G. Guarding Against the Accumulated Earnings Tax\textsuperscript{289}

In order to prevent a corporation from accumulating its current earnings and profits for the purpose of avoiding the imposition of the individual income tax that its shareholders would have to pay if the earnings were distributed to shareholders as a dividend, an accumulated earnings tax is imposed.\textsuperscript{280} The provisions of the statute apply to all corporations except personal holding companies and other specified corporations.\textsuperscript{291} Where the accumulated earnings tax applies, the rate of tax is $27\frac{1}{2}\%$ of the accumulated taxable income up to $100,000 and $38\frac{1}{2}\%$ on the excess.\textsuperscript{292}

We have seen that the stock ownership test and the gross income test which are applied in the personal holding company area are mathematically precise and that where a closely held corporation is alert to the situation, slight changes in the amount of particular types of income may avoid entirely the severe penalty of the personal holding company surtax. There is no such certain method of avoiding the accumulated earnings tax, for the circumstances under which this surtax will

\textsuperscript{287}. \textsection{562}(b). The rule applies to a portion of the distribution in partial liquidations. Proposed Reg. \textsection{1.562-1}(b). Where the complete liquidation occurs within 24 months after the adoption of the plan, all distributions qualify as deductions. Proposed Reg. \textsection{1.562-1}(b) (ii).

\textsuperscript{288}. See discussion p. 116, infra, for a consideration of those circumstances where keeping a corporation in existence as a personal holding company rather than liquidating may benefit the shareholders.

\textsuperscript{289}. For additional consideration of the accumulated earnings tax see HOLTZMAN, THE TAX ON ACCUMULATED EARNINGS, (1956); JOINT COMMITTEE REPORT, The Taxation of Corporate Surplus Accumulations, 82nd Cong. 2d Session (1952); LASSER AND HOLTZMAN, CORPORATE ACCUMULATIONS AND SECTION 102; The Accumulated Earnings Tax, 32 TAXES 823 (1954).

\textsuperscript{290}. \textsection{531}. Proposed Reg. \textsection{1.532-1}(a). This tax is in addition to the 30\% normal tax and 22\% surtax. A subsidiary corporation may have been so formed with regard to the shareholders of the parent corporation. Proposed Reg. \textsection{1.532-1}(a) (2).

\textsuperscript{291}. \textsection{532}(b).

\textsuperscript{292}. \textsection{531}. Although there is no rule prohibiting the self assessment of this tax by the corporation as occurs when the income tax return is filed, only in rare cases will this happen. Thus, the 6\% interest rate charged on tax deficiencies becomes an important factor since any assessment of the accumulated earnings tax will generally be a considerable time after the close of the taxable year to which the accumulated earnings tax relates.
be imposed cannot be reduced to mathematical rules. The uncertainty of the criteria governing the accumulated earnings tax, and the near universality of the advantage which shareholders of a profitable corporation obtain from accumulation, make this tax a formidable tax planning problem for successful close corporations.

It is where the corporation is “formed or availed of” for the proscribed purpose of avoiding income tax to the shareholders on the distribution of earnings that the accumulated earnings tax is imposed. In essence, it is the state of mind of the corporation acting through its board of directors which the courts must analyze to determine whether the proscribed purpose is present.\textsuperscript{293} Obviously, this question of subjective intent is measured, in most cases, by objective standards. However, once the accumulated earnings tax is asserted by the Commissioner, the corporation must establish a complete lack of interdicted purpose to avoid completely the application of the surtax.\textsuperscript{294}

Once it is established that the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, such showing is determinative of the proscribed purpose unless the corporation establishes the absence thereof by a preponderance of the evidence.\textsuperscript{295} There are procedures whereby the burden of proceeding on the issue of the case relating to reasonable business needs may be shifted to the Commissioner,\textsuperscript{296} but the ultimate burden of proof in an accumulated earnings tax case remains on the corporation.\textsuperscript{297}

Although the accumulated earnings tax may apply to a corporation having a large number of shareholders,\textsuperscript{298} the extremely vulnerable area is with the closely held corporation because it is there that the proscribed purpose will more readily appear.\textsuperscript{299}

\begin{footnotesize}
\begin{enumerate}
\item United Business Corp. v. Commissioner, 62 F.2d 754 (2d Cir. 1933).
\item Belaire Management Corp., 21 T.C. 881 (1954); Trico Products Corporation, 46 B.T.A. 346; aff’d 137 F.2d 424 (2d Cir. 1943); Pelton Steel Castings Co., 28 T.C. 153 (1957), aff’d 251 F.2d 278 (7th Cir. 1958); cert. denied 345 U.S. 958; R. L. Blaffer & Company 37 B.T.A. 851 (1938); aff’d 103 F.2d 487 (5th Cir. 1939). Though the proscribed purpose is present, the accumulated earnings credit may be large enough so that little or no accumulated earnings tax will result. § 535(a).
\item § 533(a). Proposed Reg. § 1.533-1(a). Also, once it is established that the corporation is a mere holding or investment corporation, such showing constitutes \textit{prima facie} evidence of the interdicted purpose. § 533(b).
\item § 534.
\item Pelton Steel Castings Co., \textit{supra}, note 294. For a discussion of this element see Kopperud and Donaldson, \textit{The Burden of Proof in Accumulated Surplus Cases}, 36 TAXES 827 (1957).
\item Trico Products Corp., \textit{supra}, note 294.
\item The procedure generally followed by the Commissioner where the imposition of this tax seems proper is to require the corporation to submit a statement of its
\end{enumerate}
\end{footnotesize}
Prior to the 1954 Code, once the existence of the proscribed purpose was shown, the entire earnings and profits for the year in issue were subject to the accumulated earnings tax. Thus, even where the corporation could show a business need, the tax applied.\textsuperscript{300} Under the present statute, in computing the accumulated taxable income, provision is made for an accumulated earnings credit which takes into consideration the reasonable business needs\textsuperscript{301} so that, in effect, only the excess earnings and profits over and above the reasonable needs of the business are exposed to the tax. Furthermore, there is available a minimum accumulated earnings credit, which is now $100,000, that takes into account the earnings and profits of the corporation of previous years.\textsuperscript{302}

Merely because a corporation is newly created does not prevent the imposition of the tax.\textsuperscript{303} If the corporation is the outgrowth of a business for which there is established information as to its needs, then the fact that the corporation has operated but a few years will not, per se, justify the retention of earnings.\textsuperscript{304} Also, a corporation may have been "availed of" for the proscribed purpose in one year and not others.\textsuperscript{305} Further, what may constitute a reasonable accumulation for the business needs of one corporation may be entirely unreasonable for a similar corporation.\textsuperscript{306}

Nearly all accumulated earnings tax controversies turn on the determination of the amounts reasonably accumulated for business needs.\textsuperscript{307}

\begin{itemize}
    \item \textsuperscript{300} The minimum credit for the year in issue is the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the end of the preceding taxable year. \textsuperscript{301}§ 535 (c) (2) \textit{as amended} by the Small Business Tax Revision Act of 1958, § 205.
    \item \textsuperscript{302} Belaire Management Corp., \textit{supra}.
    \item \textsuperscript{303} Lane Drug Company, 3 CCH Tax Ct. Mem. 395 (1944).
    \item \textsuperscript{304} Sauk Investment Co., 34 B.T.A. 732 (1936); R. C. Tway Coal Sales v. United States, 75 F.2d 336 (6th Cir. 1935).
    \item \textsuperscript{305} Cecil B. de Mille, 31 B.T.A. 1161 (1935).
    \item \textsuperscript{306} Since the court is no longer required to decide an accumulated earnings case on an "all or nothing" basis as heretofore, more cases may appear in this field. On
\end{itemize}
Although no one factor can be picked as controlling in a case involving the unreasonable accumulations issue, some helpful guideposts have evolved. The following is a partial guide in this respect:

1. The corporation may accumulate without the penalty tax amounts required for present and prospective operations. It need not finance them through loans or other arrangements.\(^{308}\)

2. The corporation can advance funds to a substantial business customer for a limited period of time without creating damaging evidence against itself.\(^{309}\)

3. However, investing substantial amounts in government obligations and other securities may indicate an unreasonable accumulation.\(^{310}\)

4. Setting aside funds for future expansions into new areas of business activity may or may not be a justification for the accumulation.\(^{311}\)

5. Loans by the corporation to its shareholders, especially where the loans are pro-rata and with little or no interest,\(^{312}\) and loans to other corporations controlled by its shareholders,\(^{313}\) substantially expose the corporation to the tax, whereas a loan from the corporation to an affiliate may be an appropriate business need.\(^{314}\)

6. The need for earnings to fund a program of self insurance of the business and its activities may be an acceptable reason for an accumulation.\(^{315}\)

7. The use of funds to redeem the stock of a minority shareholder may be an acceptable business use of funds\(^{316}\) whereas the re-

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312. Whitney Chain & Mfg. Co., 3 T.C. 1109 (1944), \textit{aff'd} 149 F.2d 936 (2d Cir. 1945); United Business Corp. of America v. Commissioner, 62 F.2d 754 (2d Cir. 1933).
demption of the stock of a majority shareholder may not.\textsuperscript{317} An accumulation in expectation of redeeming the stock of a shareholder at a later time may be questioned.\textsuperscript{318}

Although the Commissioner will use hindsight to disprove the intent of the corporation with respect to its reasons and justifications for the accumulation of earnings for a given year,\textsuperscript{319} it may prove helpful to keep full and accurate minutes of the board of directors,\textsuperscript{320} where appropriate, setting forth information concerning such things as the changing character of the business, the present and prospective plans for expansion, customer demands, contract obligations, hazards of any particular phase of the business or transactions, the type and amount of competition, the fluctuation in sales and the reasons therefor, the inventory requirements, contingent liabilities, engineering problems relating to product and equipment, a depreciation analysis and adequacy thereof for renewals and replacements, bank loans which may restrict the payment of dividends and reports prepared for the company which might otherwise reflect on the need for accumulation. Where the corporation takes action, favorably or unfavorably, as to a dividend, supporting reasons therefor should appear in the record.

The closely held corporation should note that it may now be able to avoid the exposure to the accumulated earnings tax by electing to be subject to the provisions of Subchapter S.\textsuperscript{321} However, many considerations are involved in such an election, only one of which is this tax.

III. Dividing the Business

Dividing a corporation into two or more separate business corporations can involve many unusual tax problems. The tax laws contain certain rules which if followed will facilitate the division of the business without tax consequences but which, if not followed, can result in the most disastrous tax consequences.

A. Deciding Whether to Divide the Corporation

1. Non-Tax Considerations

Generally non-tax reasons will determine whether an existing corporation should be divided. Moreover, the non-tax reasons have a particular

\begin{itemize}
  \item \textsuperscript{318} Williams Investment Co. v. United States 3 F.Supp. 225 (Ct. Cl., 1933).
  \item \textsuperscript{319} But see discussion p. 89 \textit{infra}.
  \item \textsuperscript{320} Twin City Theatres, 11 CCH Tax Ct. Mem. 454 (1952).
  \item \textsuperscript{321} In Thomas S. Lee, 12 CCH Tax Ct. Mem. 730 (1953), the court commented favorably on this factor. Cecil B. de Mille, \textit{supra}.
  \item \textsuperscript{321} See discussion p. 12 \textit{infra}.
\end{itemize}
TAX PROBLEMS OF CLOSE CORPORATIONS

significance for federal income tax purposes because tax consequences may turn upon whether the division was for business or tax avoidance purposes. Thus, in giving any consideration to dividing the corporation, a clear record should be made as to the non-tax reasons for the division. Some of these non-tax reasons may be: development of the business into separate departments; economy in future operations; employee incentive plans (e.g. stock bonus) requiring separate corporations; operations in different states required or facilitated by separate corporations; competitive factors (e.g., customers will not buy if corporation has competing department); development or acquisition of new operations; isolation of business risks, particularly where some operations are more speculative than others; strengthening of credit position; labor problems; and policy disagreements among owners.

2. Tax Considerations in the Choice

There are certain immediate tax consequences to be considered in determining whether to divide the corporation into several business entities. The advantages and disadvantages in tax rates and net tax on the total enterprise where multiple corporations are established are the same as were previously considered in pre-incorporation planning. However, it is more difficult to obtain the tax benefits of multiple corporations by dividing a business which has been successfully operated in one corporation. Thus, the benefits of the $25,000 surtax exemption and the $100,000 credit against the accumulated earnings surtax will be lost to a corporation created or acquired in connection with a division unless the taxpayer establishes that tax savings was not “the principal purpose” or “major purpose” of the transaction.

Aside from tax rates, there may be other immediate considerations under the tax laws requiring a division. One of these could be qualification under the tax laws of an employees’ pension or profit sharing plan. In order to cover a particular group of employees and exclude others it may be necessary or desirable to have the covered employees working for a separate corporation. Similarly, some compensation

322. See p. 15, supra.
323. § 269. Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957).
325. As to such plans generally, see p. 53, supra.
326. See § 401(a) (3) (A).
problems may be minimized by having officer-stockholders drawing their compensation from two or more separate corporations, so that the amount from any one corporation is reasonable and related to the particular function performed.\textsuperscript{327}

Future tax considerations may also warrant dividing the corporation. Such a division may yield greater flexibility in later obtaining tax benefits from sales, distributions and changes in ownership. But to make a division possible, and to make it in a way which will secure such ultimate objectives, advance planning — and in some cases long-range planning — is necessary.

\section*{B. Advance Planning for the Division}

In general there are two tax favored methods for dividing a corporation:

1. Creating a subsidiary corporation, by transferring part of the corporate assets to a new corporation, with the parent corporation retaining the stock of the subsidiary.\textsuperscript{328}

2. Transferring the assets of a separate business operation of the corporation to a controlled subsidiary and distributing the subsidiary's stock to the individual stockholders of the first corporation (proportionately or disproportionately).\textsuperscript{329}

A corporation may be divided by either method tax-free, provided the rules in the statute for application of the method are followed. Other methods of dividing a corporation — involving a sale of assets or a transfer by distribution of assets to stockholders — will involve taxable transactions, possibly resulting in capital gains or dividends.\textsuperscript{330}

The rules governing the first of these methods of division are not complex. Generally, they are the same as in the case of any new incorporation,\textsuperscript{331} except that, as we have seen, the tax advantages of having multiple corporations may be denied unless the subsidiary is necessary for the conduct of a separate business.

\textsuperscript{327} For example, a reasonable salary from a manufacturing corporation and a commission from a sales corporation is more likely to pass scrutiny than a salary and bonus from a combined corporation. See also discussion of contingent compensation, supra p. 51.

\textsuperscript{328} This would be a tax-free transfer under \$ 351. See p. 19, supra.

\textsuperscript{329} The series of steps would be tax-free if qualifications are met under \$\$ 351, 368(a) (1) (D) and/or 355.

\textsuperscript{330} Thus a distribution of part of the assets of a corporation is generally a dividend, \$ 301, unless treated as a payment in exchange for stock (such as a partial liquidation, \$ 346, or as a disproportionate distribution or distribution in complete termination of interest to a shareholder, \$ 302(b) (2) or (3), and then it may be a capital gain.

\textsuperscript{331} \$ 351.
The second method of dividing a business, involving the further step of distribution of stock of the subsidiary corporation to individual shareholders, is far more complex. The statute requires, in addition to a business purpose, that the distributed corporation have a record of active conduct of a separate business. At a minimum this will ordinarily require a showing of separate income and expenses of the activity to be identified as the separate business. Better still would be a showing that the activity is a separate branch or department of the corporation, with separate books and records. Formation of a subsidiary corporation and transferring to it assets and functions to constitute a "separate business" will most clearly formalize the separate identity of the activity, although a history of separate business conduct may still be necessary for full tax benefits. Thus, we get back to the importance of advance planning to build a record of active conduct of a separate business. Such a record is necessary for each of the more complex methods of corporate division. These methods are discussed below.

C. SPIN-OFFS

Where a corporation is divided into two or more sister corporations owned by the same stockholders, this is called a "spin-off." The term is derived from the method of "spinning off" or transferring assets of a corporation to a controlled subsidiary corporation and distributing the stock of the subsidiary to the individual stockholders of the first corporation.

A distribution of stock of another corporation always poses the tax question of whether the receipt of such stock is itself an income realizing event to the stockholders (and is therefore subject to tax) or is merely a new form for continued ownership of the same assets (formerly represented in the old stock) which continue in corporate solution. The tax law resolves this problem by a series of rules, which, if satisfied, permit such a distribution of new stock to be made tax-free. If the rules are not satisfied, the distribution of the stock will result in a taxable gain or dividend. The statute provides the following series of rules for a tax-free division of a corporation by a spin-off:

332. § 355(a)(1)(C).
333. Reg. § 1.355-1(c).
334. § 301. See also Reg. § 1.355-2(f). A recent highly publicized situation where a distribution of stock of another corporation will result in a dividend is the proposed distribution of General Motors stock by DuPont. See, e.g., N. Y. TIMES, Aug. 15, 1958. § C, p. 30.
335. § 355.
1. **Ownership requirement.** The parent corporation must acquire sufficient ownership of the stock of the subsidiary corporation to constitute at least 80% control. This control must exist immediately prior to the distribution of the subsidiary's stock to shareholders.

2. **Complete distribution of stock.** The parent corporation must distribute all the stock and securities of the subsidiary held by it (or must distribute at least the control stock and establish that any retained was not for tax avoidance purposes). This rule is designed to prevent the shareholders from having their cake and eating it, by receiving some stock (on which they can profit on later sales) and still retaining the control of the business through the parent corporation. However, if the required distribution is made, it is immaterial for purposes of a tax-free spin-off whether the stock is distributed pro rata to all stockholders, whether there is a corresponding exchange of stock of the parent corporation, and whether the distribution is in connection with a "plan of reorganization."

3. **Conduct of separate businesses.** The parent corporation and subsidiary corporation each must have been engaged in the active conduct of a trade or business for five years before the distribution of the subsidiary's stock to the individual shareholders, and each must be so actively engaged immediately after the distribution. This requirement, that

336. § 355(a)(1). As defined in § 368(c), the required control is ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

337. Such control cannot be acquired by purchase (in a taxable transaction) within 5 years prior to the distribution. § 355(b)(2)(C) and (D).

338. § 355(a)(1)(D). Reg. § 1.355-2(d). However, distribution of stock acquired by purchase within five years will result in gain or a dividend to the shareholders. § 355(a); Reg. § 1.355-2(f)-1.

339. § 355(a)(2)(A). Reg. § 1.355-3(a). But a disproportionate distribution will be scrutinized to determine whether some stockholders are being benefited by way of a gift or compensation.

340. § 355(a)(2)(B). But where securities of the subsidiary are distributed without surrender of securities or securities of a smaller principal amount are surrendered, gain or dividend consequences will result. §§ 355(a)(3) and 356(d); Reg. § 1.355-2(a). For other consequences of other property distributed without an exchange, see infra, p. 82.

341. § 355(a)(2)(C). Reg. § 1.355-3(c). Another form of corporate division may be accomplished by a plan of reorganization under § 368(a)(1)(D), discussed infra, p. 82.

342. § 355(a)(1)(C). Reg. § 1.355-4. For this purpose, a corporation satisfies the active conduct of business test if it is the holding company for a corporation so engaged. See § 355(b)(1)(B) and (2)(A). Thus if the parent corporation is merely a holding company it need not separately satisfy the active business requirement.
separate businesses were conducted for five years and are continued, is the heart of the statute because it embodies the concept that the distribution resulting in ownership of stock of sister corporations involves only a change in form and not an income realizing event. Consistent with this requirement is a rule that if the corporation acquires another business by purchase, it must own or control such business five years before a tax-free spin-off may be made of the purchased business. What constitutes a separate trade or business will be discussed later.

4. Non-tax avoidance purpose. The distribution of the stock of the subsidiary must not be a device used principally for distribution of earnings. Thus, if a division of a corporation in a spin-off is followed shortly by sale of stock of one of the corporations, the seller may be inviting the Internal Revenue Service to treat the transaction as one which was intended to produce a disguised dividend. However, the mere fact that there is such a sale does not result in dividend treatment; but a sale pursuant to an arrangement negotiated or agreed upon prior to the distribution will probably be fatal. Because of the uncertainty whether the Government will, after the event, accept the taxpayers motives, it is frequently advisable to obtain an advance ruling from the Internal Revenue Service before undergoing a spin-off transaction. The Internal Revenue Service will issue advance rulings on such transactions; but along with other facts to be submitted to satisfy the requirements of the statute, it will require a showing of business purpose for the transaction.

As previously indicated, the separate business test is the heart of the statute and may be the most difficult for the close corporation to satisfy. To constitute a separate business there must be an activity involving collection of income and payment of expenses which can be identified as a separate business. This will require more than merely an incidental activity, such as ownership of real estate housing the business. However, an incidental activity can be made a separate business. Thus, mere ownership of the plant or building in which the business operates does not establish a separate real estate business; but if real estate is

343. Purchase here means an acquisition in a taxable transaction (i.e. gain or loss recognized on the purchase or sale). Thus the restriction does not apply to a tax-free acquisition made within the five year period such as under § 368(a)(1)(A), (B) or (C).

344. §§ 355(a)(3) and 355(b)(2)(C) and (D).

345. § 355(a)(1)(B); Reg. § 1.355-2(b); Rev. Rul. 55-103, 1955-1 CUM. BULL. 31.


347. Reg. § 1.355-1(c).


349. Reg. § 1.355-1(c)(2) and (d), Examples (2) and (3).
placed in a subsidiary corporation and income producing real estate
opérations are conducted for five years (including rent from the parent
corporation) such subsidiary has a separately identified business and
after such five year period its stock may be distributed in a spin-off (as-
suming the other statutory tests are met).\textsuperscript{350} Usually operations of an
activity in a different location will support a finding that it is a separate
business.\textsuperscript{351} However, diverse fields of business will most clearly support
the case for separate businesses.\textsuperscript{352}

cautions must be exercised in a spin-off that no money or property is
distributed to the shareholders other than the stock or securities per-
mitted under the rules just described. A distribution of "other property"
may be treated as a dividend.\textsuperscript{353}

D. Split-Ups

A split-up is a method of dividing the corporate business by splitting
it into several independent entities and permitting the shareholders to go
their separate ways. The statute permits a split-up to be made tax-free.
This is particularly important in facilitating the splitting up of close
corporations where the stockholders have had differences of opinion as
to operations and each desires to go his own way with a segment of the
business. However, to achieve a tax-free split-up, the pattern provided
by a number of sections of the tax law must be followed.

The basic statutory provision treats a split-up as a "reorganization,"\textsuperscript{354}
but the steps involved are substantially the same as those in a spin-off,
namely, (1) the transfer of corporate assets to a controlled subsidiary\textsuperscript{355}
and (2) distribution of stock of the subsidiary to individual share-
holders.\textsuperscript{356} Furthermore, the separate business requirements of a spin-off
must be satisfied where the stock of the controlled subsidiary is dis-
tributed.\textsuperscript{357} The difference between this "reorganization" and the typical
spin-off is that the reorganization will involve an exchange of stock,

\textsuperscript{350} Rev. Rul. 56-554, 1956-2 CUM. BULL. 198; Rev. Rul. 56-557, 1956-2 CUM.

\textsuperscript{351} See Reg. \S 1.355-1(d) Examples (8), (9), (10), (13), (14) and (15);
150.

\textsuperscript{352} Rev. Rul. 56-117, 1956-1 CUM. BULL. 180; Rev. Rul. 56-451, 1956-2 CUM.
BULL. 208; Rev. Rul. 57-311, 1957-2 CUM. BULL. 243. But see Rev. Rul. 56-266,
1956-1 CUM. BULL. 184.

\textsuperscript{353} \S 356(b). If the distribution is in an exchange, it may result in capital gain
or a dividend. \S 356(a).

\textsuperscript{354} \S 368(a)(1)(D).

\textsuperscript{355} This must be a tax-free transfer under \S 351.

\textsuperscript{356} This must qualify as tax-free under §§ 354, 355 or 356.

\textsuperscript{357} See Rev. Rul. 57-114, 1957-1 CUM. BULL. 122.
whereby some stockholders will receive the stock of the subsidiary corporation in exchange for their stock in the parent corporation. Thus, the original business may be effectively divided into independent corporations, each with its separate shareholders.

This division of business entities need not be made in proportion to the stock of the former shareholders to be tax-free to them on the exchange. However, if there is a difference in value which has not been determined on an arms-length basis, then the Internal Revenue Service may take the position that the stockholder receiving a disproportionately greater value has either received taxable compensation or a gift from the other stockholders. On the other hand, and to avoid this type of problem, the Internal Revenue Service has recognized that cash may be distributed by the corporation in such a reorganization so that the split-up of assets is proportionate to stockholdings.\textsuperscript{358} While such a distribution of cash will not prevent the transaction from otherwise being tax-free, the receipt of such cash may be capital gain or a dividend.\textsuperscript{359}

These statutory provisions for dividing a business are very useful but it should be clear that their use requires careful planning — frequently well in advance — and attention to details under the statute. The disastrous tax consequences of a misstep suggest that an advance favorable ruling should be obtained from the Internal Revenue Service whenever possible.

IV. Shifting Control and Bailing Out

A. Redemption of Stock to Pay Death Taxes

Frequently the estate of a decedent lacks liquidity because a substantial portion of its assets consist of shares of stock in small and closely held corporations for which there is little or no ready market. Thus, the estate is oftentimes forced to sell shares of stock back to the corporation, with the inherent danger that such redemption may be treated as a dividend by the Internal Revenue Service. Congress, however, has for many years afforded relief in this area by specifically providing that the redemption by the corporation of a limited dollar amount of stock which qualifies, is to be treated as a sale or exchange thereby eliminating the threat of dividend consequence by reason of the redemption. Where this relief provision, now Section 303, applies, the relief from dividend con-

\textsuperscript{358} See Rev. Rul. 56-655, 1956-2 CUM. BULL. 214.

\textsuperscript{359} §§ 302 or 356(a). A sale of part of the stock to other shareholders prior to the reorganization so that the split-up will be proportionate to the value of stockholdings and the only cash received will be as a result of the sale of stock may restrict the cash received to capital gain treatment.
sequence in most cases will mean relief from all income tax consequences, for the adjusted basis of such stock for the purpose of determining the gain or loss from the redemption will generally be the value for estate tax purposes.\textsuperscript{360} Congress has recently afforded additional limited relief to an estate, a part of which consists of an interest in a closely held business, by permitting a portion of the federal estate tax to be paid in installments at 4\% interest over a selected period up to ten years.\textsuperscript{361}

At the outset, it should be noted that the application of the provisions of Section 303 does not, as the unofficial title suggests, require that the redemption proceeds be used to pay death taxes or that the transaction of redemption be only with the executor of the decedent's estate. As will be seen, the statute has broader application and is frequently a very helpful means to accomplish a bailout objective.

Not all shares of stock in the decedent's estate are accorded favorable redemption treatment. The shares of stock which can qualify for favorable redemption treatment under Section 303 must, first of all, be stock which for federal estate tax purposes is included in determining the gross estate of a decedent. This would include not only stock which the decedent owned at death, but also stock transferred in various forms prior to death.\textsuperscript{362} Secondly, the value of all of the shares of the stock (regardless of class) of the particular corporation included as a part of the decedent's gross estate, must comprise more than 35\% of the value of decedent's gross estate or more than 50\% of the value of decedent's taxable estate.\textsuperscript{363} These percentage requirements are alternative and only one need be satisfied for the stock to qualify. There is a special rule within the framework of these alternative percentage rules dealing with stock of two or more corporations, under which, if more than 75\%

\textsuperscript{360} § 1014. Under the conditions specified in § 304, stock qualifying under § 303 may be acquired by a related corporation or a subsidiary corporation. Redemptions covered by § 304 are subject to the provisions of § 303 where applicable. Reg. § 1.304-1. This route may be necessary where a shortage of funds exists in the issuing corporation. See Code Commentary, MERTENS, INCOME TAXATION, § 104 (1954). § 303 is but one tool when seeking to obtain cash from the corporation upon the death of a shareholder. Other means, such as complete termination of shareholder interest and disproportionate redemptions under § 302, should be explored. See p. 87, infra. For additional discussion of § 303, see Roeder, \textit{Distributions in Redemption of Stock}, N.Y.U., 15TH INST. ON FED. TAX, 475 (1957).

\textsuperscript{361} Small Business Tax Revision Act of 1958, § 206, adding § 6166 to the Code.

\textsuperscript{362} For example, stock transferred in contemplation of death (§ 2035), stock transferred \textit{inter vivos} by decedent to certain trusts (§§ 2036-8), stock held in joint ownership (§ 2040) and stock held by trusts where decedent possessed a taxable power of appointment (§ 2041). Reg. § 1.303-2(b).

\textsuperscript{363} § 303(b) (2).
in value of all of the stock of each of two or more corporations is included in decedent's gross estate, such stock is treated as stock of a single corporation for the purpose of applying the 35% rule and the 50% rule.\textsuperscript{364}

Where Section 303 is applicable, the amount of stock that may be redeemed under its protection is subject to two limitations. The redemption is protected only to the extent of the dollar amount of taxes\textsuperscript{365} and funeral and administration expenses\textsuperscript{366} and the redemption must occur after the death of the decedent and within a limited period of time which, as a general rule, will expire 4½ years after decedent's death.\textsuperscript{367}

Subject to these requirements, considerable flexibility is provided. There is no restriction as to the class of stock that may be redeemed,\textsuperscript{368} nor is it necessary that the redemption of the stock be directly from the estate of the decedent. Generally, anyone who acquired the stock qualifying under Section 303 from the decedent either prior to, at or after the death of the decedent under circumstances where the stock is included in decedent's estate is entitled to the favorable redemption treatment.\textsuperscript{369}

\textsuperscript{364} For examples of the 35%, 50% and 75% rules, see Reg. § 1.303-2(c) (2). The requirements for the ten-year installment payment of the qualifying portion of the federal estate tax are similar. The interest in the closely held business — either proprietorship, partnership or corporation — included in the gross estate must exceed either 35% of the value of the gross estate or 50% of the value of the net estate of the decedent; the interests in two or more closely held businesses are treated as one where more than 50% (not 75%) of the total value of each is included in decedent's gross estate.

\textsuperscript{365} Estate, inheritance, legacy and succession taxes (including any interest collected as a part of such taxes) imposed by reason of decedent's death. § 303 (a) (1). The taxes do not have to be an obligation of the estate, as for example, an inheritance tax imposed on the beneficiary.

\textsuperscript{366} Allowable as deductions to the estate. § 303 (a) (2). There is no requirement that the funeral and administration expenses be deducted in the federal estate tax return. Cf. Deduction of such items in the income tax return of the estate. Rev. Rul. 449, 1956-2 CUM. BULL. 180.

\textsuperscript{367} § 303 (b). Reg. § 1.303-2(e). Note that extensions of time within which to file the decedent's federal estate tax return do not extend the general 4½ year rule.

\textsuperscript{368} Reg. § 1.303-2(c) (1). Non-voting or preferred shares may be redeemed so as not to disturb the voting shares.

\textsuperscript{369} Reg. § 1.303-2(f). The regulations exclude such persons as a purchaser of the stock, a legatee of decedent's estate who accepts the stock in satisfaction of a monetary bequest and a donee from a person to whom the stock passed from the decedent. There appears, however, to be authority to support the theory that a donee should be entitled to claim the benefit of § 303 where the donor could so qualify for such benefit. Bessie B. Hopkinson, 42 B.T.A. 580 (1940), aff'd., 126 F.2d 406 (2d Cir. 1942), non-acq. 1941-1 CUM. BULL. 16. Note that where the widow of the decedent receives stock in satisfaction of a monetary bequest, such stock will not qualify for favorable redemption treatment. Such a disqualification may exist under certain types of marital deduction formula clauses. See Rev. Rul. 70, 1956-1 CUM. BULL. 325. Cf., Estate of Kantner 50 N.J. Super. 582, 143 A.2d 243 (1958).
The redemption may be proportionate or disproportionate as desired. And finally, where there has been a receipt of additional stock after the decedent's death with respect to stock which qualified under Section 303, the additional stock (new stock) will qualify under Section 303.\textsuperscript{370} This means, for example, that preferred stock (Section 306 stock) could be distributed as a stock dividend and such stock would qualify for favorable treatment under Section 303 where the stock with respect to which the distribution is made qualifies. Thus, a quantity of such "new stock" could be redeemed without disrupting the balance of voting control.

An election to pay the estate tax in installments will not interfere with a Section 303 redemption. However, unless the estate pays on the deferred federal estate tax an amount equal to the proceeds of a Section 303 redemption, the redemption may cause an acceleration of the time for payment of the deferred installments.\textsuperscript{371}

As we have seen, Section 303 affords favorable redemption treatment only to the extent of the taxes and expenses of the estate. If that dollar limitation is exceeded, the excess does not vitiate the application of Section 303, but the excess is not protected by Section 303.\textsuperscript{372} The dollar limitation under the statute apparently is not prorated or shared on any basis of priority.\textsuperscript{373} The rule seems to be that the statute will be applied on a first come, first served basis. Because of these rules, all prior redemptions of stock by the corporation which might fall within the provisions of Section 303 should be examined carefully before any shares are redeemed where the provisions of Section 303 are necessary to protect the shareholder against the treatment of the proposed redemption as a dividend.

The corporation which redeems shares protected by Section 303 may find that the redemption increases its exposure to the imposition of the accumulated earnings tax.\textsuperscript{374} However, the Government will not assert that

\textsuperscript{370} Providing the "new stock" has a cost basis determined by reference to the cost basis of the old stock which qualified under § 303. Examples of this are receipts of stock in reorganizations under § 368, distributions under § 355, exchanges under § 1036 and distributions under § 305. Reg. § 1.303-2(d).

\textsuperscript{371} § 6166(h)(1)(B); Small Business Tax Revision Act of 1958, § 206.

\textsuperscript{372} The entire redemption may come within a favorable provision of § 302 in which case the entire redemption is protected.

\textsuperscript{373} In applying the dollar limitation of § 303, all stock qualifying under § 303 which has been redeemed is taken into account in determining whether the limitation has been exceeded even though one or more previous redemptions may have qualified for favorable redemption treatment under another provision of the Code. Reg. § 1.303-2(g).

\textsuperscript{374} § 531. See discussion of the redemption of stock and its effect on the imposition of the accumulated earnings tax, p. 72, supra, p. 89 infra. Such a redemption does not qualify for the dividends paid deduction when computing accumulated taxable income. Proposed Reg. § 1.562-2(b).
the surviving shareholders received a taxable economic benefit from the amount paid by the corporation in redemption of the shares except where it discharges their pre-existing obligation to purchase such shares, or where the shares purchased are transferred to the surviving shareholders.  

B. BUY-SELL ARRANGEMENTS AND STOCK REDEMPTIONS

Typically the close corporation is actively managed by the persons who own it or by persons related to them. Accordingly, upon the death and sometimes upon the retirement of one, his estate and the surviving owners are faced with the choice of disposing of the business through sale or liquidation, or of making some arrangement for its continuance. Frequently it is found desirable to effect the complete withdrawal of the deceased or inactive owner’s interest or at least the withdrawal of more than that permitted by Section 303, discussed above, in order to give the estate of the deceased owner greater liquidity than is there possible. More often than not, such withdrawal is insisted upon by the surviving owners who prefer not to be associated with persons who are inexperienced or at least inactive in the business. It is for these reasons that the buy-sell arrangement has come into such common use in close corporations.

1. Advantages in Making the Arrangements Inter Vivos

There are distinct advantages both to the corporation and to the shareholders in arranging the buy-sell at the outset rather than attempting to negotiate the arrangement after one of the owners has died or retired. From the corporation’s viewpoint, it assures to the extent possible that the business will be continued and not liquidated; it assures harmonious operation by eliminating or reducing the position of inactive and inexperienced shareholders; it assures continuity of management and of business policies; and, in the proper case, it may be used as an inducement to younger executives. From the viewpoint of the shareholders, the terms can better be negotiated while the shareholder-managers are still alive and active, if for no other reason, because a fair deal is more likely when made before it is known who will first die or retire; it assures the owners continued supervision and control while they are active; it assures to the extent possible liquidity to the owner’s estate upon his death; and by postponing the buy-out until after his death may result in complete avoidance of income tax. More importantly, the

375. See note 391 infra. Note that where the redemption price is less than the value of the shares for federal estate tax purposes, the loss may be denied. § 267.
376. Upon death, the cost of the shares to the decedent becomes immaterial, and the fair market value of the shares at his death becomes their basis under § 1014. If the buy-out is at that price, there is no gain or loss to the estate. Indeed, the buy-out price may itself have the effect of fixing the value at death. See note 377, infra.
buy-sell arrangement may in a proper case result in fixing the value of his shares at the date of death. These factors compel the conclusion that the buy-sell arrangement should be made while the shareholder is still active.

2. Advantages of the Corporate Buy-Out

The buy-sell may either take the form of an arrangement whereby the shares of the deceased or retiring party may be purchased by the surviving shareholders or whereby they may be purchased by the corporation. The former has a number of disadvantages. First, it is difficult for the surviving shareholders to adequately fund the buy-out from the earnings of the business. Income from dividends is available for this purpose only after it has been doubly taxed. At the same time, there are distinct limitations on the amounts payable to shareholders which may be deducted by the corporation. And the graduated tax rates on individuals leave progressively less and less as the individual's income is increased. Secondly, since it is uncertain as to which of the owners will first retire or die, each of the shareholders must accumulate funds for the buy-out of the others if this method is adopted. This multiple funding greatly magnifies the difficulties of funding the buy-out from the earnings of the business. Finally, if this method is adopted, there may be danger in later switching it to a buy-out by the corporation when it is found that the surviving shareholders are unable to fund the purchase.

In contrast, making the arrangement a buy-out of the shares by the corporation avoids these problems and has the same result on the continuing shareholders percentage interest, as if each had purchased his prorata part of the decedent's shares. The necessary funds can be accumulated more readily in the corporation's hands than in the hands of the individuals because the funds accumulate after only one tax — that at the corporate level — and because the corporate rates are not progressive. And the funds so accumulated are available for use in the business in the interim. The multiple funding problem is also reduced somewhat and the corporation's rights and obligations under the arrangement may be transferred to one or more of the shareholders or to a third party acceptable to them if it later becomes necessary or desirable to do so.

Thus, the corporate buy-out is generally much more advantageous

377. Estate Tax Reg. § 20.2031-2(b). The estate must be bound to sell at death either by enforceable contract or by option binding upon it. A "first refusal" arrangement is not sufficient. Also the agreement must be at "arms' length." Possibly the shareholder must not be free to sell at a higher price during his lifetime. Cf. Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932).

378. See discussion infra p. 90.
from the tax viewpoint than is a buy-out by the continuing shareholders. However, also from the tax viewpoint, the corporate buy-out involves much more difficult problems for the corporation, and for the continuing shareholders, as well as for the deceased or retiring shareholder or his estate. We now turn to an examination of these problems.

3. Problems of the Corporation

The problems of the corporation in a corporate buy-out arise under the accumulated earning tax.\(^{379}\) Basically the question here is whether the buy-out arrangement is one of the "reasonable needs of the business." A strong argument may be made that it is such in the close corporation. Avoiding possible liquidation\(^ {380} \) assuring continuity of consistent business policies and continuity of management by proprietors active and experienced in the business are certainly as important as programs for expansion of the existing business and other matters which the Internal Revenue Service and the courts have recognized as "reasonable needs of the business." Indeed, they may be more important since they go to the continued existence as well as the continued success of the venture. That the courts may recognize the soundness of this position is indicated in a number of the decided cases.\(^ {381} \) There is, however, one recent decision which appears to go almost to the extent of holding that a corporate buy-out results \textit{ipso facto} in the corporation's being "availed of" to avoid surtax on its shareholders.\(^ {382} \) It is to be hoped that this decision will be strictly limited in its application.\(^ {383} \)

Until the matter is clarified by further decisions, it should be assumed that the accumulated earnings tax may be asserted and may be sustained for the year during which the corporation buys the shares of a deceased or retiring shareholder, and possibly also in years during which funds are accumulated for that purpose.\(^ {384} \) In weighing this risk, it should be kept

\(^{379}\) § 531 et seq.; see p. 72, supra.

\(^{380}\) E.g., judicial dissolution upon disagreement between equal shareholders. See \textsc{Ohio Rev. Code} § 1701.91 (A) (4).


\(^{383}\) There is some indication of this. See Penn Needle Art Co., 17 CCH Tax Ct. Mem. 504 (1958).

\(^{384}\) E.g., by payment of premiums on life insurance designed to fund the corporation's eventual obligation. \textit{Cf.} The Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1951), which holds that key-man insurance policies carried to protect the corporation against loss of the insured's services are "reasonable needs of the busi-
in mind that the 27½% and 38½% taxes involved are imposed on the corporation, not the shareholders, and are applied only for the particular years to the earnings retained after corporate tax.\textsuperscript{385} Under the sharply graduated rates, the individual shareholders frequently would be required to pay far more than 27½% or 38½% if the same amounts were currently distributed to them as dividends. Furthermore, the accumulated earnings tax does not necessarily apply to the entire amount accumulated in the current year. A credit may be obtained for such portion as is within the "reasonable needs of the business."\textsuperscript{386} In these circumstances, it should be recognized that while risk of the accumulated earnings tax exists in using the corporate buy-out route, its application may be something less than catastrophic and may indeed be the preferable alternative.\textsuperscript{387}

4. Problems of the Continuing Shareholders

Until recently, it appeared to be well settled that the continuing shareholder realized no income when the corporation purchased the shares of another.\textsuperscript{388} Here again, there was a recent decision which cast some doubt on the matter.\textsuperscript{389} In the Holsey case, the retiring shareholder

\textsuperscript{385} Thus, even if the accumulated earnings tax is applied, the effective tax rate upon the corporation is approximately 65.2% (52% plus 27½% of 48%) on the first $100,000 of the year's net profit after ordinary income taxes and approximately 70% (52% plus 37½% of 48%) on any excess over $100,000.

\textsuperscript{386} § 535 (c) (1). This gives rise to an interesting problem as to which comes first. If the corporation has admittedly reasonable business needs and some which are questioned, the corporation seems to be entitled to accumulate whatever the former requires. \textit{Quaere:} Whether this is true where the funds are earmarked for the latter, e.g., life insurance to fund a corporate buy-out?

\textsuperscript{387} If the rule of Pelton Steel Castings Co., 28 T.C. 153 (1957), \textit{aff'd}, 251 F.2d 278 (7th Cir.), \textit{cert. denied}, 356 U.S. 958 (1958), is applied, there is no dividends paid credit allowed for the amount paid out because it is a "preferential" distribution under § 562(c). See Reg. § 1.562-2(b), Example (2).

\textsuperscript{388} Fred F. Fischer, 6 CCH Tax Ct. Mem. 520 (1948); Ray Edenfield, 19 T.C. 13 (1952), \textit{acq.}, 1953-1 CUM. BULL. 4. See also Tucker v. Commissioner, 226 F.2d 177 (8th Cir. 1955). This of course excludes cases such as Wall v. United States, 164 F.2d 462 (4th Cir. 1947), where the continuing shareholder bought the shares and resold them to the corporation or was legally obligated to buy them and caused the corporation to discharge his obligation.

was a corporation controlled by the immediate family of the continuing shareholder. Also in that case, the continuing shareholder held an option on the other's shares. He assigned the option to the corporation, and the corporation purchased the shares upon exercise of the option on the same day. While the Tax Courts' decision contained language broad enough to hold that every continuing shareholder realizes income when the corporate assets are used to retire the shares owned by others, the Internal Revenue Service never regarded the decision as going so far. Its recent reversal by the Circuit Court and the Service's prompt acquiescence therein appear again to settle the matter.

5. Problems of the Withdrawing Shareholder or His Estate

By far the most intricate problems are those which arise for the withdrawing shareholder or the estate of the deceased shareholder. Every corporate buy-out is a redemption. The basic problem, therefore, is to assure that the redemption is "not essentially equivalent to a dividend," in order to avoid the receipt of ordinary dividend income. To accomplish this, it is desirable to make the buy-out either a "disproportionate redemption" or a "complete" termination of interest. While it is possible to accomplish the desired result otherwise, the precise limits of "disproportionate" and "complete" are defined in the statute with mathematical exactness and, hence, serve as a surer haven.

The ease or difficulty which may attend the effort to make the corporate buy-out "disproportionate" or "complete" depends upon whether the shareholders are related within the ownership attribution rules, whether more than one class of shares is outstanding and, if so, the type of shares they are.

Ownership attribution: Prior to 1954, it was immaterial that shares in a corporation were owned by other persons related to the taxpayer whose shares were redeemed. Capital gain resulted notwithstanding that

390. The National Office issued a number of unpublished rulings after the Holsey and Zipp cases, note 389, *supra*, that the continuing shareholder did not so realize income. The National Office refused to rule where, as in the Holsey case, there was a relationship between the retiring and the continuing shareholders within the ownership attribution rules of § 318 or where there was a preexisting arrangement for purchase by the shareholder instead of the corporation.


392. § 317(b).

393. Under the "basket" provision of § 302(b) (1). The other references are to §§ 301(a), 302(a), 302(b) (2) and (3).
Indeed, the Commissioner once proposed to change the applicable regulations to make ownership by related persons a factor to be considered in determining whether a redemption was equivalent to a dividend but later abandoned that proposal. Therefore, we may safely begin with the premise that there is no "common law" rule of ownership attribution in this area. This is important because in enacting the ownership attribution rules in 1954, Congress has, intentionally or otherwise, left certain gaps and, in view of this history, it seems clear that the courts will not attempt to bridge them. The ownership attribution rules should be carefully reviewed with this in mind. Only a sketch of the rules is here possible.

a. Each partner is deemed to own a proportion of the stock owned, directly or indirectly, by the partnership and owned, directly or indirectly, by all of the other partners; and the partnership is deemed to own all of the stock owned by all of its partners. The rule applies even to a limited partner who has no interest except in firm capital. For this purpose, partnership includes many relationships not regarded as partnership under local law.

b. Each beneficiary of an estate is deemed to own a proportion of the stock owned, directly or indirectly, by the estate and owned, directly or indirectly, by all of the other beneficiaries; and the estate is deemed to own all of the stock owned, directly or indirectly, by all of its beneficiaries. The stock specifically bequeathed to one beneficiary is attributed proportionately to others who in fact have no interest in it. Stock is attributed proportionately to a beneficiary whose only interest is a specific bequest of other property — e.g., real estate. These rules


396. The constructive ownership rules referred to herein are found in § 318.

397. It is not clear whether the attribution is in proportion to the interests in firm profits, firm losses or firm capital. These can be and sometimes are different.

398. See § 761(a) and compare § 7701(a)(2).

399. Reg. § 1.318-3(a) limits this rule to beneficiaries with a direct present interest in the property or income. Thus, remainder interests are excluded whether vested or contingent. The smallest direct interest brings the rules into operation, however. Actuarial determinations are not material here. For this purpose, "estate" means the probate estate under local law. It does not include inter vivos dispositions which are deemed part of the estate for death tax purposes — e.g., revocable trusts, gifts in contemplation of death, etc. See Hacker, Corporate Distributions, Liquidations and Related Problems, 30 OHIO BAR 749, 753-54 (1955); Winton and Hoffman, Stock Redemptions under Sections 302 and 318, 10 TAX L. REV. 363, 372 (1955).
cease to operate after the estate is closed and cease to operate as to a particular beneficiary when he ceases to be such. Accordingly, the result under the estate attribution rules will frequently depend upon careful timing of the redemption.

c. Each beneficiary of a trust (other than a remote contingent beneficiary) is deemed to own a proportion of the stock owned directly or indirectly by the trust, by other such beneficiaries, and by the grantor or other person treated as the substantial owner of the trust. Similarly, the grantor or other person treated as the substantial owner of the trust is deemed to own all of the stock owned, directly or indirectly, by the trust and by all of the beneficiaries (other than remote contingent ones). And the trust is deemed to own all of the stock owned, directly or indirectly, by its beneficiaries (other than remote contingent ones), by its grantor or other person treated as the substantial owner of the trust. There is no attribution between a grantor and his trust where he is not deemed to be the substantial owner nor after he ceases to be regarded as such owner. Nor is there attribution under the trust rules after the trust has terminated. Accordingly, again the result under the trust attribution rules will frequently depend upon careful timing of the redemption.

d. Stock owned, directly or indirectly, by a corporation is deemed to be owned by a person owning 50% or more in value of its stock in proportion to the value of its stock owned by that person. Stock owned directly or indirectly by such a 50% or more shareholder is deemed to be owned by the corporation. The effect of this rule when a corporation's shares are owned, directly or indirectly, 50-50 by two persons is that each of them is deemed to own all of the stock in another corporation owned by the corporation and by the other shareholder. This rule operates even as to a person who owns nothing but non-voting or nothing but preferred shares.

e. A person is deemed to own stock upon which he holds an option to purchase. This rule in terms applies to options which are exercisable only at a time or upon a condition which has yet to occur. But there is no attribution if the option is released or has expired unexercised prior to the redemption. Therefore this rule also can be avoided by causing

400. See Reg. § 1.318-3(a).
401. Under the so-called "Clifford Trust" provisions of §§ 671-78.
402. Reg. § 1.318-1(b) (1) limits double attribution by providing that a corporation is never deemed to own shares in itself. It will also be noted that under the corporation attribution rules there is no attribution of shares owned by a corporation which itself has no stock outstanding, e.g., a non-profit corporation, even though family controlled.
the option to be released prior to the redemption.\textsuperscript{404} Finally it will be noted that the option rule does not apply to "put" but only to "call" options, and may not apply to contracts under which both parties are bound.

f. A person is deemed to own the stock owned, directly or indirectly, by his spouse, his children, his grandchildren and his parents. This is in practice by far the most important of the ownership attribution rules. It does not require attribution of grandparents' stock to grandchildren, nor attribution between brothers and sisters, nor attribution between in-laws. More importantly, the statute prohibits attribution under the family rule to one and use of the family rule to attribute ownership to another.\textsuperscript{405}

The foregoing is the barest outline of the ownership attribution rules. In each corporate buy-out careful inquiry must be made as to the existence of these various relationships and the applicable rules must be tested and retested to be certain that unusual combinations of them do not exist which might frustrate the desired result. Also in planning for a corporate buy-out after death of one of several shareholders, the several possible sequences of death must be taken into account if any of them are related within these rules. The rules may and frequently will apply differently depending upon the order of deaths. Obviously, it is also necessary to take into account the estate plan of the parties in such cases because of the family, trust and estate attribution rules supra. As suggested, frequently the problems posed by the ownership attribution rules can be solved by careful timing of the redemption or by taking other precautionary measures in advance of the redemption.

Redemption when shareholders unrelated: Where the shareholders are not related, making the buy-out a "disproportionate" redemption or a "complete" termination of interest may be simple or not depending upon the types of stock which the corporation has outstanding. If there is only one class of stock outstanding, the redemption can be "complete" simply by requiring that all the stock of the particular shareholder or his

\textsuperscript{404} But the option should not be reinstated immediately thereafter or the release may well be regarded as a sham. Presumably, the option rule applies to an option to acquire stock no matter what form it takes and thus includes convertible preferred stock and convertible bonds which in effect give the holder an option to acquire stock.

\textsuperscript{405} § 318(a)(4)(B). Double and multiple attribution is possible under the other rules or a combination of them. Also the family rule may be used to attribute to one person and other rules used to reattribute to another or vice versa. But see Reg. §§ 1.318-1(b)(2) and 1.318-2(a), Example (2).

\textsuperscript{406} For convenience the term "related" within the attribution rules will be used herein to include any situation where any of the ownership attribution rules or a combination of them may apply and the term "unrelated" will be used where none of them may apply.
estate be purchased at one time. Also if there is only one class of stock, the redemption can be “disproportionate” provided two tests are met: first, that immediately after the redemption the particular shareholder owns stock possessing less than 50% of the voting power; and secondly, that his ratio of the voting stock after the redemption is less than 80% of his ratio of the voting stock before the redemption.\footnote{407} It is thus important that the buy-out occur in big bites. As a practical matter it is much preferable that the buy-out occur as a complete termination of interest. If purchase of so much at once would otherwise require too great a cash drain from the corporation, it is possible for evidences of corporate indebtedness to be issued in part payment.\footnote{408}

If there is more than one class of stock outstanding, the solution is somewhat more difficult. There can be a “complete” termination of interest only if the particular shareholder’s shares of both classes are all redeemed at once. But as noted above the redemption can be “disproportionate” even though it is not a “complete” termination of interest. If both classes are voting stock (preferred\footnote{409} or common), sufficient shares of either or both classes must be redeemed at the same time to meet the two tests stated above. If both classes are common stock, \textit{e.g.}, one voting and the other non-voting, the redemption must in addition to these tests meet the 20\% cut back test valuing both classes of common together in order to be treated as “disproportionate.” It will be observed that where the two classes are voting common and non-voting preferred, all or a sufficient part of the voting common may be redeemed and the buy-out will be a “disproportionate” redemption even though the preferred is left undisturbed. This, it will be seen, provides an attractive alternative to the issuance of corporate indebtedness on the buy-out to avoid its possibly crippling the corporate finances.\footnote{410}

\footnote{407} \textit{I.e.}, there must be a 20\% “cut back” in his \textit{ratio} of voting stock. See example in Reg. \S 1.302-3 (b). \textit{Cf.} erroneous examples in \textsc{Sen. Rep. No.} 1622, 83d Cong., 2d Sess., 234-235, 253 (1954), which fail to take into account the other requirement that the shareholder own less than 50\% voting power after the redemption. If there is a series of redemptions pursuant to a plan, these requirements must be tested against the effect of the entire series of redemptions. \S 302 (b) (2) (D).

\footnote{408} If the amount of this debt poses a credit problem for the corporation, the corporate notes may be subordinated to bank indebtedness, etc., as meets the case, providing that the debt will be regarded as genuine debt under the tests discussed \textit{supra}, p. 33. The corporate indebtedness should have a fixed maturity; the interest and the principal should be payable in all events; and the debt should not be subordinated to general creditors. See Reg. \S 1.302-4(d).

\footnote{409} Reg. \S 1.302-3 (a) provides generally that stock which has no vote until the happening of an event such as default in payment of dividends is not voting stock for this purpose until the event occurs.

\footnote{410} It will also be noted that preferred stock issued as a stock dividend or in a recapitalization will be “tainted” stock under \S 306 in the hands of the recipient.
Thus, once satisfied that the parties are unrelated, the corporate buy-out can usually be brought within one or the other of the protected categories without encountering unduly serious problems. However, it should be emphasized that it is the relationships which exist at the time of the redemption, not those at the time the arrangement is made, which are important. Therefore, the buy-out arrangement must be frequently reviewed and possibly revised to take any new relationships into account.

Redemption when shareholders related: Where the shareholders are related, considerably more thought must go into planning the corporate buy-out as a "complete" termination of interest or a "disproportionate" redemption. Here again, however, the problems differ depending upon the types of shares which the corporation has outstanding. If there is only one class of stock outstanding, the buy-out of all of the particular shareholder's shares may be a "complete" termination of interest even where he would otherwise be deemed to continue owning some other person's shares because of the family attribution rules. Put another way, if it would be "complete" if there were no family attribution rules, it may still be "complete." The statute\(^{411}\) provides that in determining whether there has been a "complete" termination of interest, the family attribution rules shall not apply if certain requirements are met. Aside from certain ministerial acts to be performed, these are (a) that the taxpayer whose shares are redeemed not be an officer, director or employee or otherwise have any interest in the corporation after the redemption,\(^{412}\) (b) that he not acquire such an interest within 10 years thereafter, (c) that he not have acquired any of the redeemed shares within 10 years theretofore from a person related to him at the time of the redemption\(^{413}\) and (d) that no related person own at the time of the redemption stock acquired directly or indirectly within 10 years theretofore from the taxpayer whose shares are redeemed.\(^{414}\) The latter two requirements do not apply if the acquisition or disposition, respectively, did not have avoidance of Federal income tax as one of its principal purposes.\(^{415}\) Thus, where the family attribution rule would otherwise prevent the

\(^{411}\) § 302(c)(2).

\(^{412}\) Here again an interest as a creditor is permitted, allowing corporate indebtedness to be issued on the buy-out.

\(^{413}\) It will be noted that stock acquired within 10 years from a person deceased at the time of redemption is not covered. See § 302(c)(2)(B)(i). Nor is the decedent's estate the same "person" as the decedent.

\(^{414}\) See § 302(c)(2)(B)(ii) and comments in note 413, supra.

\(^{415}\) In any event, acquisition by the decedent's estate of shares upon the decedent's death can hardly be regarded as having been motivated by tax avoidance.
buy-out from being a "complete" termination, it is still often possible to bring it into this protected class. It should be emphasized that the estate and other attribution rules may still apply to prevent its being a "complete" termination. The special provisions referred to operate only to avoid the effect of the family attribution rules and only in determining whether there is a "complete" termination of interest. They do not apply in determining whether the redemption is "disproportionate." In this area the family attribution rules and the others are given full effect. But even applying the attribution rules, the less than 50% after and the 20% cut back tests, supra, may be met in the particular case.

If the parties are related and there is more than one class of stock outstanding, the basic problems are the same. In the proper case, there can be a "complete" termination of interest despite the family attribution rules if the particular shareholder's shares of both classes are redeemed at once and if the special requirements are met. And even where these requirements cannot be met or where one of the other attribution rules interposes, it still may be possible to make the buy-out a disproportionate redemption. The only difference is that the ownership attribution rules must be applied to both classes of stock in determining whether the two voting stock tests and the common stock test are met.

It is not possible to deal with the almost infinite number of combinations possible under the ownership attribution rules. Their application poses a distinct challenge to the ingenuity of the tax advisor particularly where the corporation has several classes of stock outstanding. But experience reveals that more often than not the several gaps in the rules may by careful planning be used to bring the buy-out within the protected categories. One final word of warning is indicated. The ownership attribution rules are the subject of current study and may be changed. The practitioner must keep alert to any such development and be prepared to revise existing buy-out arrangements in their light since it is the statute in effect at the time of redemption, not that which ap-

416. Because the spouse, children, grandchildren and parents are natural objects of a decedent's bounty, they may be beneficiaries of his estate. If any such persons are also shareholders, the estate attribution rules will operate to prevent a complete termination of the estate's interest even though all the stock actually owned by it is redeemed.

417. E.g., where the decedent's son owns a minority of the voting stock or some non-voting preferred and is also a beneficiary of the estate whose shares are bought out, and if sufficient other shares are owned by unrelated persons.

418. See particularly notes 403, 413 and 415, supra.

plied when the buy-sell arrangement was made, which will govern its
tax consequences.

C. LEVERAGE STOCK

1. Use to Shift Control

The use of leverage stock is a common device by which senior execu-
tives may shift, or begin to shift, control of the corporation to younger
executives and prepare for the ultimate retirement of their own interest
in the company. "Leverage stock" is a term used to refer to stock which,
because nonparticipating securities are outstanding, reflects more than
its share of any change in the corporate net worth. The obvious exam-
ple and the most usual method is common stock where there is preferred
stock outstanding. To illustrate, if a corporation has a present value of
$200,000 and its entire net worth is represented by common stock, an
increase of 50 per cent in the value of the company will produce a 50
per cent increase in the value of each share of stock. If half the net worth
of the company had been represented by common stock and half by pre-
ferred stock which does not participate in earnings above its preferred
dividend, an increase of 50 per cent in the net worth of the company
would all be reflected in the common stock, which would double in value.
If there had been $150,000 of preferred outstanding so that only 25 per
cent of the net worth was represented by common, the same increase in
the value of the whole corporation would increase the value of the com-
mon to $125,000 or more than five times its original value. This effect
is called leverage, and it will be noted that the smaller the proportion of
common outstanding, the greater is the leverage.

Where the senior executive, who is now the owner of most or all of
the stock of the company having only common outstanding, contemplates
the possibility of ultimate death or retirement, he may find the leverage
device useful both as a means of retaining and encouraging competent
younger executives who will carry the company on after his retirement or
death, and at the same time providing greater security for that part of
his estate which is invested in the company. The senior executive con-
verts his investment from common stock to common and preferred, a
sufficient amount being represented by preferred to reduce the value of
the common to a point where the younger executives can buy a signifi-
cant amount of it. If the company prospers, the prosperity is reflected
in the stock owned by the younger men who are running the company.
At the same time the increased value provides greater security for the
preferred stock. A further advantage is that the death of the older
man, if the stock is to be retained, need not leave a widow in voting
control of the company unless there is default in the dividends.
2. Issuance of the Preferred Stock

The preferred stock may be issued in a recapitalization, which qualifies as a tax-free reorganization under the Code\textsuperscript{420} in which the senior executive exchanges part of his common stock for preferred stock. No gain is recognized on the exchange. It should be noted at this point that while debt securities would provide leverage for the common just as would preferred stock, the amount of debt securities issued in exchange for common will be treated as a dividend,\textsuperscript{421} defeating the entire plan.

It is also possible to issue the preferred stock as a dividend on common and this will similarly receive tax-free treatment.\textsuperscript{422} Note, however, that the preferred stock in both cases may be subject to ordinary income tax when and if it is sold or redeemed, as will be explained below.

3. Acquisition of Common by Junior Executives

The simplest method to accomplish this is to have the junior buy shares of common stock directly from the senior. This method permits the senior to obtain some cash for his investment currently, if that is what he wants. Alternatively, the junior executive could buy new stock directly from the corporation, or provision may be made for acquisition of the stock through stock-option or stock-bonus plans, which have already been described. Unless the stock is issued pursuant to a qualified restricted stock option, however, the executive is subjected to ordinary income tax to the extent that the value of the stock issued exceeds the amount paid for it, and the corporation obtains a corresponding deduction.

4. Retirement of the Senior Executive's Shares

It is often contemplated as a final step that the shares retained by the senior executive will be redeemed by the company or sold to the younger executives. At this point, however, attention must be given to Section 306, which under some circumstances may make the sale or redemption taxable as a dividend.\textsuperscript{423} In general, this section applies to preferred stock (sometimes referred to as "tainted" or "hot stock") which is issued in a tax-free transaction in which distribution of cash instead of the preferred stock

\textsuperscript{420} \S 368(a) (1) (E); Reg. \S 1.368-2(e) (3).
\textsuperscript{421} \S 354(a) (2).
\textsuperscript{422} \S 305(a).
would have been taxable as a dividend. Thus it applies where the corporation distributes the preferred as a dividend on the common or where preferred is received in exchange for common in a reorganization.\textsuperscript{424} This means that it will usually apply in the situation here involved.

If the preferred is "hot stock," Section 306 provides that the amount realized on its sale or redemption is ordinary income. There are a number of exceptions, however, three of which may be applied in meeting present problems:

(1) Where all the stock of the shareholder, both common and preferred, is sold or redeemed at once.\textsuperscript{425}

(2) Where the common with respect to which the preferred was issued is sold or redeemed at the same time or earlier.\textsuperscript{426}

(3) Where the stock is not disposed of until after the death of the shareholder.\textsuperscript{427}

The "hot stock" problem can also sometimes be resolved by issuing the preferred stock under such circumstances that it is not "hot stock" at all, such as:

(1) By issuing it at a time when the company has no earnings and profits to distribute.\textsuperscript{428}

(2) By issuing it in exchange for all the common stock of the shareholder involved.\textsuperscript{429}

(3) Probably by issuing it in an exchange which, if cash had been distributed instead, would have been a disproportionate redemption entitled to capital-gain treatment.\textsuperscript{430}

Whether or not the stock is "hot stock," redemption (but not sale) requires consideration of Section 302, dealing with the treatment of stock redemptions as dividends. In general these provisions can be avoided only by redeeming all the stock held or by redeeming enough common stock to have a "substantially disproportionate redemption."

It must be remembered in interpreting both the "hot stock" provisions and the redemption provisions that attribution rules apply.\textsuperscript{431}

One further possibility of avoiding both the "hot stock" and redemption problems is to give the preferred stock to a charity. Deduction of

\begin{itemize}
  \item 424. § 306(c) (1); Reg. § 1.306-3(d).
  \item 425. § 306(b) (1).
  \item 426. Reg. § 1.306-2(b) (3).
  \item 427. Reg. § 1.306-3(e).
  \item 428. § 306(c) (2). Query, whether this fails if later in the same year the corporation accumulates earnings? Compare § 316 with Reg. § 1.306-3(a).
  \item 429. Since the effect is not the same as a stock dividend. § 306(c) (1) (B).
  \item 430. For the same reason. See Reg. § 1.306-3(d).
  \item 431. § 318. See supra p. 91.
\end{itemize}
the value of the stock may yield as many net dollars to the high-bracket taxpayer as sale at capital-gain rates, and no income is realized.\textsuperscript{432}

Two other dangers in the use of leverage stock should be mentioned: First, the prices and proportions used should be fair and not a means of concealing a gift or a compensatory bonus. Second, there is some danger that use of corporate capital to eliminate the retiring shareholder may advertise the presence of funds not needed in the business and invite assertion of the accumulated earnings tax.\textsuperscript{433}

D. Sale of Assets to Step-Sister Corporation

1. Mechanics Involved

Where over a period of years a closely held corporation has accumulated assets not strictly necessary in the operation of the business, the problem of shifting control to the younger executive is aggravated by the necessity of compelling the younger executive to buy an interest in the unneeded assets. This problem can often be resolved by selling only the necessary assets to another newly formed corporation. The new corporation, whose stock is issued principally to the younger executives, then buys the needed assets from the old. Even if business necessities require that the new corporation obtain all the assets of the old, the same thinning effect can be accomplished by a sale on credit, the old company being left with notes or with cash and notes. Alternatively, or even in conjunction with a credit sale, the old company can lease a part of its assets to the new instead of selling them. After the sale, the old corporation can, if desired, be liquidated.

2. Tax Results

If the transaction works as intended, the transfer of the assets to the new company is a taxable transaction, resulting in a new cost basis to the purchaser. Unless the old corporation is then liquidated under Section 337, discussed below, it will have a taxable gain.

The old corporation may or may not decide to liquidate. If it remains in existence, it is possible that the nature of its income may make it a personal holding company, subject to prohibitive tax on undistributed earnings.\textsuperscript{434} The personal holding company tax can be avoided, however, by paying out the earnings in dividends, and it is often found that

\textsuperscript{433} §§ 531-35.
\textsuperscript{434} §§ 541-47.
the advantages of retaining the old company outweigh its disadvantages, particularly if the stockholders have a very low cost basis on their stock and would be subjected to a large capital gains tax which would be avoided if they retained their stock during the rest of their lives.

If the old corporation is to be liquidated, Section 337 makes it possible to avoid the tax on the corporation's gain while taxing the shareholders on their gain realized on liquidation. To take advantage of this section it is necessary that the plan of liquidation be adopted before the sale takes place and that the liquidation of the old company be completed within 12 months after adoption of the plan. Where the assets of the old corporation consist not only of cash but also of other properties, as in cases where the new corporation has bought some of the assets and leased others, the liquidation has the further advantage that the shareholders by paying a capital gains tax, obtain a new cost basis for the properties distributed, measured by their value at the time of the liquidation. This is often a considerable advantage, particularly if the value of the properties is substantially in excess of their cost basis in the hands of the corporation, since the new basis serves also as the cost for depreciation of the property in the hands of the shareholder, permitting him to recover at ordinary tax rates much of the basis which he acquired at capital gain rates.

Where the distribution includes property other than money, however, it should be noted that as the gain is computed with respect to the value of the property as well as the amount of the cash, the stockholders will want to receive sufficient cash in the transaction to take care of their capital gains tax on the property. It is important to arrange the sale to the new corporation with a large enough down payment to assure adequate cash upon liquidation.

Where the properties of the old corporation are sold on credit, it should not be mistakenly assumed that the capital gains tax which results will be subject to the provisions deferring tax on installment sales. If the corporation is to remain in existence, instead of being liquidated, the sale by the corporation will be a taxable sale and will be subject to the installment sales provisions. However, where the corporation is liquidated within the year, the corporation is relieved of its tax, so that the installment sales provisions are irrelevant. The shareholder pays the capital gains tax currently on the value of the notes received in liquidation and is not entitled to use the installment method at all.

435. § 334(a).
436. § 453.
437. § 337.
3. Tax Problems

Some problems arising out of the reorganization provisions of the Code may exist where some of the shareholders of the old corporation are also shareholders of the new. Where there are no common shareholdings between the two companies, the transaction is clearly a sale between the two companies; but two other problems may nevertheless arise. One is the possibility of a tax on improperly accumulated surplus.\^438\^ In any situation where the terms upon which the business is sold indicate that some of the cash of the old corporation was not actually necessary to the operation of the business, it may well occur to the examining agent to try to impose the accumulated earnings tax for open years preceding the year of sale. This tax does not apply to earnings accumulated in the year in which the liquidation takes place, because the distribution in liquidation is a deduction in computing the income accumulated.\^439\^ It is also necessary before using this plan to determine whether the corporation may be a collapsible corporation.\^440\^ The danger of qualifying as a collapsible corporation is greater of course if the corporation is less than three years old, since the gain on liquidation may, under some conditions, be ordinary income;\^441\^ but the expiration of three years does not necessarily terminate that status, and the provisions exempting the corporation from tax on the sale are not applicable to collapsible corporations.\^442\^ Where some of the shareholders of the old company own some of the stock of the new, another set of problems arises, making it necessary to be sure that a sufficient shift in the control is present. Assume, for example, that the senior executives own all the stock of the old corporation, and wish to have the business assets sold to a new and smaller company in which the junior executives will be permitted to buy some of the stock. A question may immediately arise as to whether the new corporation is simply the old under another name, the excess assets having by this means been extracted from the corporation, with the effect of a dividend to the old shareholders.

If the old shareholders have 80 per cent control of the new company, the entire transaction is a reorganization\^443\^ and dividend treatment re-
If less than 80 per cent control is retained, the transaction may still be a redemption taxable as a dividend on the theory that the new corporation is a mere continuation of the old, which has redeemed part of its outstanding stock and issued some new. The requirements for a disproportionate redemption, providing capital gain treatment, must therefore be satisfied. And even in such a case, it would probably be well to obtain a ruling in any case where the old shareholders are to retain an interest in the new, although the Service has ruled favorably where an interest less than 50 per cent was retained for good business reasons. It might be better in such a case to use an entirely different device, such as the leverage stock plan.

This problem can arise not only where the senior executives have elected to retain some interest in the new corporation, but also where the junior executives own all of the new corporation, but also had some interest in the old. There may be a reorganization under § 368(a)(1)(D) where one or more of the shareholders of the old are in 80 per cent control of the new. Thus if a senior executive who owned stock of the old company caused the sale of its assets to a new corporation all of whose stock was owned by three junior executives who together owned a material interest in the old company, distribution of cash and debt instruments in liquidation of the old company might be held to result in a dividend to the three junior executives on the ground that the transaction was a reorganization, and in their case had the effect of the distribution of a taxable dividend. This, however, involves consideration of the complex “reorganization” field and particularly whether the concept of “continuity of interest” is satisfied.

E. SALE OF STOCK TO A RELATED ORGANIZATION

1. Sale To A Related Corporation Some of Whose Stock Is Owned By the Sellers

Instead of selling assets under the plan described above, it is possible to accomplish a shift of control by the sale of the stock of the old company. This can be followed, if desired, by a liquidation of the old company into the purchasing company. The effect of such a transaction differs substantially, however, in that all of the assets of the old company pass over to the new, and the selling shareholders do not, as in the asset sale, retain a part of the assets. Any cash received by the old shareholders must come directly from the buying company.

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444. § 356(a)(2).
445. § 302.
446. § 302(b)(2).
**Shift of control necessary.** The Code expressly provides\(^4\) that where a shareholder or shareholders of a corporation controlling as a group either 50 per cent of the voting power or 50 per cent of the value, transfer any part of their stock to another corporation in which they have 50 per cent control or more, the amount received is taxable as a dividend to the extent that the acquiring corporation has earnings and profits, and where the old corporation is liquidated within the taxable year, the earnings and profits of both corporations would no doubt be taken into account for this purpose.

**Use of new company.** Where the shareholders of the old corporation own less than 50 per cent of the purchaser, this problem should not arise. This suggests the possibility of having the younger executives organize a new company to buy the stock of the old, giving notes for the purchase price. The old company is then liquidated into the new, and any excess cash in the old company is applied upon the debt. The future earnings of the business are now available to the new corporation to pay the balance of the purchase price. It should be noted that if the old corporation is liquidated within two years after the purchase, the buying company takes the assets at a new cost basis computed with respect to the purchase price of the stock, just as if the transaction had been a sale of assets.\(^5\)

There is one distinct advantage in the sale of stock followed by a liquidation over the sale of assets. Although the result is the same so far as the buying company is concerned, it is possible, where the stock is purchased, for the selling shareholders to receive installment obligations. As noted above, where the assets are sold, the installment method of reporting income is not available if the obligations of the purchaser are distributed to the shareholders of the old company.

The sale of either assets or stock to a related corporation is a particularly effective device where a complete shift of ownership is to be accomplished. Where any substantial interest in the continuing venture is to be retained, complications arise which make it advisable either to obtain an advance ruling from the Service or to use one of the leverage plans described above.

### 2. Sale To A Related Charitable Organization

Instead of selling stock to a corporation owned by other individuals, it is possible to obtain some of the same advantages by sale or gift to a charity. Where a part of the stock is sold to a charity, the remainder, even if it is less than 50 per cent, may as a practical matter be sufficient to keep control, particularly where the charity is one established by or

\(^4\) § 304.

\(^5\) §334(b) (2).
substantially supported by the principal stockholders of the company. As noted above, a gift of stock to a charity may often obtain results as valuable in dollars as a sale.

There are a number of dangers in such a transaction, however, particularly where a sale is involved. First, if the price is excessive, the transaction will be a "prohibited transaction," and the tax exemption of the charity will be lost. The exemption may also be lost with respect to any income which the charity finds it necessary to accumulate in order to have enough to make the purchase. Where the charity does not pay cash, but is instead to pay the purchase price over a period of time, further difficulties arise, since the use of income coming from the company to pay the debt may not only imperil the exemption, but may be treated as income to the seller. Finally, where the sale of the stock to the charity is a loss transaction, the loss may be denied in the case of a related charity if a bona fide sale is held not to have occurred.

Finally the warning should be repeated that in all of these transactions, the rules on attribution of stock ownership must always be consulted.

F. REORGANIZATION-TYPE BAIL-OUTS

Each of the methods of bail-out thus far discussed, with the principal exception of redemption of stock to pay death taxes, involves a substantial shift in control. As pointed out below, upon a complete liquidation, the earnings and profits of a corporation can generally be removed at capital gain rates without a shift of control. Thereafter the liquidated business may be terminated or continued in a non-corporate form. Such a liquidation may have business disadvantages; and the problem here considered is whether it is possible to continue the business in corporate form after the shareholders withdraw excess assets or prepare for a later bail out by thinning capital. A simple distribution of the assets or of evidences of indebtedness would clearly have dividend consequences to the shareholders even if it should take the form of a recapitalization. We here examine whether more sophisticated types of transactions give more palatable tax results.

450. § 503(c)(4).
451. § 504(a).
452. Emmanuel F. Kolkey, 27 T.C. 37 (1956), aff'd, 254 F.2d 51 (7th Cir. 1958); Rev. Rul. 54-520, 1954-2 CUM. BULL. 128.
453. § 267(b)(9).
454. Some of the other exceptions discussed elsewhere in this article are redemption of preferred stock issued at the time of incorporation, and payments on shareholder debt and shareholder installment sale contracts, leases and licenses.
455. See discussion infra, p. 110.
456. §§301, 356(a)(2).
1. Forms of Transaction To Be Considered

There are four types of transactions to which consideration should be given.

   a. Reorganization followed by liquidation: Where an existing corporation transfers its business assets to a new corporation in exchange for stock or stock and securities and then the old corporation is liquidated, the shareholders receiving the new stock and securities and the excess assets, the shareholder gain will frequently be subject to dividend treatment. If the transfer of assets is a "reorganization," the subsequent liquidating distribution will be regarded as simply part of the reorganization plan. The consequence is likely to be treated as dividend income, on one or the other of two theories. First, the distribution to the shareholder of cash or other assets, or the value of debt securities in excess of the principal amount of debt securities surrendered, is almost certain to be taxed under the "boot" provision as a dividend to the extent of the gain, if a dividend would have resulted without the reorganization step. Furthermore, the distribution may be taxed as a dividend where a direct redemption would not have been. Second, the entire transaction viewed as a whole may be regarded as merely a series of integrated steps designed to bail-out corporate earnings and, on this basis, the entire distribution, not limited to the amount of the gain, may receive dividend treatment.

   b. Tax-free transfer followed by liquidation: Where less than "substantially all" of the old corporation's assets are transferred, the transaction will not be a reorganization. The transfer of assets from the old corporation to the new corporation may still be a non-taxable incorporation, however, even though "control" of the new corporation "immediately after" the transaction is passed from the old corporation to its shareholders.

457. § 368(a) (1) (D) as read with §§ 354(b) and 355.
459. Since in this case the transaction is not regarded as an exchange, § 301 would be applicable.
460. The transaction constitutes a "reorganization" only if either substantially all of the assets of the old corporation are transferred to the new or the assets retained by the old corporation constitute a separate business within all the technical requirements discussed earlier in this article. §§ 368(a) (1) (D) and 354(b). Thus, generally, the assets which can be withdrawn by the shareholders in the course of the transaction without destroying its character as a "reorganization" are limited to an insubstantial amount, which is usually assumed to be 10% or less of the corporate net worth. This method therefore does not present attractive bail-out possibilities in any event.
ers by the liquidating distribution. Here, however, the shareholders' gain on the liquidation is recognized in full, including that measured by the stock and securities of the new corporation received by them. While this method avoids dividend consequences under the boot provision, it too involves the risk that the new corporation will be regarded as in effect merely a continuation of the old corporation, with the result that the entire transaction is treated as having the net effect of a dividend.

c. **Taxable transfer followed by liquidation:** It is of course possible for the old corporation to transfer its assets to the new corporation in a manner which neither constitutes a reorganization nor a tax-free transfer for stock or securities under Section 351. For instance, the transfer can be made for cash or for securities. Even in such a case, however, the risk of dividend consequences is not avoided unless there is a substantial shift in ownership or control. As has been pointed out elsewhere in this article, a sale to a step-sister corporation may be regarded as a reorganization. In general, we believe this risk is significant wherever there is a 50% or greater continuity of interest between the old corporation and the new one; but there may be some risk wherever a material stock interest in the old corporation owns a majority interest in the new one. If the dividend risk is successfully avoided, however, this transaction can be advantageous. Gain to the old corporation on the sale may be avoided by adopting a plan of liquidation before the sale and completing the liquidation within twelve months.

d. **Liquidation followed by tax-free transfer:** Generally it is safe to assume that where a series of integrated steps are involved, the order in which they are undertaken will not change the result. This is generally true where the sequence considered above is reversed by first liquidating the old corporation. The assets are distributed to the shareholders who retain the excess assets and transfer the business assets, with a stepped-up basis, to a new corporation for its stock or stock and securities. If the situation, after both steps are taken, differs from the situation before in a manner which if differently accomplished would constitute a reorganization, the Internal Revenue Service and the courts may well hold that

461. § 351(c).
462. See p. 103, supra.
463. Rev. Rul. 56-451, 1956-2 CUM. BULL. 189; cf. Reilly Oil Co. v. Commissioner, 162 F.2d 753 (8th Cir. 1947). It should be noted that in this ruling emphasis was placed on the business purpose of the continuity of interest. See also Austin Transit, Inc., 20 T.C. 849 (1953), acq. 1954-1 CUM. BULL. 3, which indicates that the introduction of a new equity interest exceeding 20% may be sufficient to avert a reorganization, at least where the business assets are divided among several corporations. Note, however, the transaction involved in the case followed immediately after a purchase of all of the corporation's stock.
464. § 337.
there is a reorganization with the same dividend consequences as if there were a direct distribution of the excess assets.\textsuperscript{465}

The dividend exposure does not exist if the liquidation and reincorporation are in fact not integrated steps. If a considerable period elapses after liquidation and before reincorporation, the transaction should be safe from attack. This element of safety is probably in direct ratio to the length of the interval. It hardly needs to be said that liquidations and reincorporations oft-repeated may well be regarded as evidence of an integrated bail-out program.

2. Summary of Conclusions for Planning Purposes

It should be clear from the foregoing discussion that attempting to bail-out a corporation by a transaction which is in the nature of a reorganization is a highly hazardous business. Taxpayers who, for a business reason, which ordinarily would mean a reason other than a desire to separate excess assets from the business, desire to enter into a transaction of this kind will be well advised to obtain a ruling upon the tax consequences of the transaction. In the absence of a ruling, it may be safe to rely on the Austin Transit decision if the facts of that case are substantially duplicated; it may be safe to transfer assets to a new corporation in a taxable transfer before or after the liquidation where a new 50% equity interest is included; and it may be safe to reincorporate after a liquidation if the separateness of the two steps can be clearly demonstrated. Short of these situations, the tax consequences of the transaction are difficult indeed to predict.

G. Liquidation and Continuation of the Business
in Non-Corporate Form

There remains to be considered one further method of bailing out of a corporation. It is the liquidation of the corporation and the continuation of the business. The problems inherent in the usual corporate liquidation — where the business too is liquidated — are taken up later in this article. Here only the special problems of liquidating the corporation — wholly or in part — but continuing the business are considered.

1. Partial Liquidation

A partial liquidation — the distribution of some of the assets of a corporation under prescribed circumstances in cancellation of an appro-

\textsuperscript{465} E.g., Survaunt v. Commissioner, 162 F. 2d 753 (8th Cir. 1947); Reg., \S 1.331-1(c). But see United States v. Arcade Co., 203 F.2d 230 (6th Cir. 1953). For a thorough discussion of “step transaction” cases, see Mintz and Plumb, \textit{Step Transactions in Corporate Reorganizations}, N.Y.U. 12TH INST. ON FED. TAX 247 (1954).
appropriate part of its outstanding stock — is taxed as an exchange, and therefore generally at capital gain rates. Accordingly, it is an effective way of bailing out. But it is available only when the prescribed circumstances are present; and they are not common.

The touchstone of a partial liquidation is a contraction in the business. Section 346(b) of the 1954 Code describes a transaction which will meet this touchstone in language which closely parallels the five-year rules for separating an incorporated business which have been discussed earlier. Section 346(a) declares that other redemptions of part of the stock of a corporation may qualify if they are not "essentially equivalent to a dividend," and it is clear that this language is intended to preserve the authority of the case law arising under earlier revenue acts. Those decisions held that a distribution would qualify only where there is a genuine contraction in the business and only to the extent attributable to the resulting contraction in the capital actually required for the business.

Since few corporate managements want to plan on contracting their businesses, partial liquidations are rarely effective tools for long-range planning.

2. Complete Liquidation

Earlier we considered the business and tax advantages and disadvantages of carrying on a business in an incorporated form. In general, we observed a net advantage (apart from federal income tax) to the use of a corporation; but the advantage is not always so great as to preclude a decision to revert to a proprietorship or a partnership where the tax advantages to be gained are substantial. They may be substantial in the three following situations.

a. Large accumulated earnings: A complete liquidation ordinarily results in payment of capital gains tax on the entire appreciation in value of the business. Where the accumulated earnings are relatively large in proportion to the appreciation of fixed assets, however, the advantage to be obtained from distribution of the excess cash at capital gains rates

466. See p. 76, supra.
469. See p. 10, supra.
may outweigh the disadvantage of a capital gains tax paid on the appre-
ciated business assets.\footnote{The capital gains tax cost may in part be offset by higher depreciation de-
ductions resulting from the liquidation.}

Of course, there is a risk that the value which the corporation and
its advisors believe its assets have, or which its books show, will not be
accepted by the Internal Revenue Service. This risk is particularly acute
where a corporation has patents, trade-marks and similar intangibles from
which substantial income is produced, or where it may have valuable
good will, based on its name, its customers, or its earning capacity. Fur-
ther, as is true in every bail-out transaction, the bail-out may itself be
evidence of an excessive accumulation of earnings which will invite the
penalty tax; but the liquidating distribution will give rise to a "deduction
for dividends paid" which will generally eliminate the accumulated earn-
ings tax for the year of the liquidation.\footnote{See p. 117, infra for a more extensive discussion of the "one month liquida-
tion."} Thus a liquidation may be a
solution for, as well as a cause of, an accumulated earnings tax problem.

b. \textit{Appreciation in assets, small earnings:} Another situation which
should not be overlooked lies where a corporation has assets which have
substantially appreciated in value, and relatively small earnings and
profits. Under such circumstances, a "one month liquidation" under Sec-
tion 333 of the Code may be attractive. Such a liquidation\footnote{\S 562(b).}
results in transferring the corporate assets to the shareholders with no tax other
than a dividend tax on earnings and profits and a capital gains tax to
the extent of any distribution of cash or certain securities in excess of
earnings and profits.

On either route — a normal liquidation, or a one month liquidation
— two further precautions must be observed. One is to ascertain that the
corporation is not collapsible; this problem, which is crucial in all young
corporations, is discussed below at page 119. The other is to caution
the shareholders of the liquidated company to resist the temptation to re-
incorporate the business assets too promptly. Unless the circumstances
are exceptional, any reincorporation prior to the happening of some
event not foreseen at the time of the liquidation which justifies the rein-
corporation, is subject to attack on the ground that it was planned from
the outset. If the attack is successful, the transaction may be found to
be a reorganization, pursuant to which the excess assets distributed are
taxable as a dividend.

c. \textit{Realization of small business stock losses:} The Small Business
Tax Revision Act of 1958 has created one additional situation in which
a liquidation of a corporation followed by continuation of the business in
non-corporate form for a time may be advantageous. As previously described in this article, when a "small business corporation" (as defined in Section 1244 of the Code) has issued "Section 1244 stock" and has not prospered, its shareholders are entitled to treat losses (not exceeding $25,000 in any one year, or $50,000 in the case of a joint return) realized on the sale or exchange of their Section 1244 stock as ordinary losses, chargeable against ordinary income from other sources and subject to carry-forward and carry-back as though a business loss. "Section 1244 stock" means, in general, any common stock issued for cash or most types of property under a plan adopted after June 30, 1958, when no other offer was outstanding, provided that the issuing corporation meets at the time of the loss certain requirements as to active business (which are waived if the corporation has operated at a loss) and meets at the time of the adoption of the plan certain requirements as to size (i.e., that capital paid in after June 30, 1958 including the amount offered under the plan, not exceed $500,000, and book net worth, including such amount, not exceed $1,000,000).

These requirements are not hard to meet, and it seems clear that a liquidation is a "sale or exchange" under Section 1244. The result is that high-bracket taxpayers who extend equity financing to small business corporations may find it profitable to reflect the corporation's losses in their own tax returns by liquidating the corporation. The advantage will be particularly great if the corporation has accumulated such large initial losses that it will not itself be able to apply all of the losses against its income in the five year carry-forward period.

V. Liquidating the Business

Very little can happen to a corporation the tax impact of which cannot be affected by careful planning. This is as true of the liquidation of an incorporated business as of the other important events in its life. The most important tax effects of such a liquidation are felt by the shareholders; but the liquidation problems of the corporation cannot be ignored.

A. Problems of the Corporation

Choosing whether to distribute assets in kind. The most fundamental choice confronting corporate management when it decides to liquidate the business is between a sale of the assets followed by distribution of the proceeds, and a distribution in kind. Generally, no gain or loss is recognized to the corporation upon distribution of assets in kind. And as
has been shown elsewhere, generally it is possible to arrange non-recognition of gain or loss to a corporation on its sale of corporate assets following adoption of a plan of liquidation. Often, therefore, the corporate tax burden is not affected by which course is followed. Occasionally, however, even where Section 337 is applicable it is important whether assets are sold before or after distribution, and these exceptions are worth noting:

First, where a corporation owns at the time of its liquidation a contract or claim for future payment of unaccrued income, and the contract or claim has no then ascertainable value, a distribution in kind may change the character of the income. What would have been ordinary income to the corporation will under these circumstances be gain from the exchange of stock for assets in liquidation, usually taxed to the shareholder as capital gain. This has long been the rule in the courts, and recently has been accepted by the Commissioner, with the admonition that only in “exceptional circumstances” will the contingencies and other uncertainties in an income right be regarded as so substantial as to prevent its valuation.

Secondly, where a corporation is a dealer, but its shareholders are not, property held by the corporation for sale to customers will upon distribution by the corporation acquire capital asset status in the hands of the shareholders. Of course, it was this situation which prompted Congress to enact the collapsible corporation concept in Section 341, and that provision must be carefully watched. Furthermore, shareholders who dispose of the property received in a number of sales, actively solicited, may have trouble establishing that their non-dealer status continues. Similarly, the opposite situation, in which a corporate capital asset would be turned into inventory property, or possibly into property held only for personal use, is also possible.

Timing the distribution. As in the case of incorporation, significant and sometimes overlooked tax savings can be obtained by astute timing of the liquidation. The Ohio franchise tax, for instance, is eliminated by dissolution of the corporation before the beginning of the calendar year. More important, where a business is subject to seasonal fluctuations, or has both income-producing and loss-producing assets, the relative tax positions of company and shareholder can be controlled by the mechanics

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473. See p. 102, supra.
475. Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956).
476. See, e.g., Reynolds v. Commissioner, 155 F.2d 620 (1st Cir. 1946); Hollis v. United States, 121 F. Supp. 191 (N.D. Ohio 1954).
477. OHIO REV. CODE § 5733.02.
of liquidation. There is no rule of law which prevents timing a liquidation to produce an operating loss carryback to a corporation, and where two properties or businesses are involved it may be possible to retain one — which might be the more or the less profitable one, as suited the tax situation — in the corporation during the wind-up period. Of course, a net operating loss does not survive a liquidation (other than of a controlled corporate subsidiary); and it may be important to defer liquidation of a corporation which has sustained losses until they have expired or a way has been found to employ them.

Checking for unexpected income and hidden deductions. There are a number of situations in which the liquidation of a corporation may result in its realizing income. The most important, perhaps, is the rule that a distribution of an installment obligation in liquidation (except to a controlling parent corporation) is a disposition of it which accelerates realization of the deferred gain. In some cases this consequence is serious enough to justify indefinite postponement of the liquidation. A similar rule may be applicable to the accounts receivable of a cash method corporation and to unrealized items of a corporation on the “completed contracts” accounting method; and even the definition of “accrual” may be strained to prevent a liquidation from insulating a corporation from income it is regarded as having earned.

Other possible sources of unexpected income are these: (a) A distribution of property subject to a liability, or in consideration of the assumption of liabilities, may be regarded as a sale and not a liquidating distribution. Certainly this is true where the liabilities exceed the basis to the corporation of the assets distributed. In other cases prudence dictates that, to the extent possible, liabilities assumed in a liquidation be tied by the closing papers into those categories of distributed property — generally cash and receivables — which have not appreciated in value. (b) A bad debt reserve which is no longer required must be restored to income. This principle is likely to require restoration in the final

479. The Commissioner might assert a power under § 482 to reallocate income or expense clearly to reflect income. However, this power is explicitly granted only as between two “organizations, trades, or businesses,” and § 482 has not been broadly construed.
480. The numerous and difficult problems of realizing on these losses are beyond the scope of this article.
481. § 453(d).
482. See Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951); Jud Plumbing & Heating Co. v. Commissioner, 153 F.2d 681 (5th Cir. 1946); and for a general discussion see 1 RABKIN AND JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 23.08.
return of the corporation; although it is possible that a corporation could successfully urge that such a restoration would overstate the true value of receivables and the true amount of income realized. (c) A corporate liquidation may bring into focus the cumulative effect of past errors in inventory which otherwise would have passed unnoticed with resultant serious consequences in the final corporate return.

There are also deductions available to a corporation at its liquidation which are sometimes overlooked. They include the remaining balances of amortizable items which have no value after liquidation — incorporation expenses, expenses of borrowings, broker commissions, deferred expenses and the like. They also include non-depreciable items which were capitalized for tax purposes and are not transferred in the liquidation — stock issue expenses, reorganization expenses, and, if the business is terminated, such items as purchased good will and the capitalized costs of research and development and trade-marks and trade names. They include items of property which may be abandoned — such as patents, if the expense of formal transfer is not warranted. And finally, a liquidation of a business may justify writing down the closing inventory, or increasing the depreciation allowances in the final year, on the ground that demonstrably the value of the inventory is less and the useful life of the property is shorter than book amounts would indicate.

B. PROBLEMS OF THE SHAREHOLDER

1. Deferring Capital Gain of the Shareholders

In the great majority of instances in which the business of a closely held corporation is sold, the shareholders will welcome the distribution to them of the corporate assets, including the proceeds of the sale. There are, however, a number of situations in which it may be advisable to continue the corporation in existence and by so doing defer (and possibly eliminate entirely) the capital gain tax of the shareholders which would normally attend the distribution.

a. Continuing corporation as personal holding company: If the shareholders are of advanced age (particularly if the corporation has little or no gain or has a loss on the sale of its assets) it may be advantageous from the tax standpoint to continue the corporation as a personal holding company. The principal advantage of such a continuation

484. §§ 541-47. § 541 imposes a tax of 75% on a corporation's "undistributed personal holding company income" (as defined in § 542) not in excess of $2,000 and 85% on the balance of such income. The tax is in addition to the regular corporate income taxes. The situation will rarely arise in which it will be tax wise deliberately to incur such penalty tax. This discussion, therefore, contemplates that the corporation annually will make sufficient proper (see § 562(c)) distributions to avoid such tax.
would be that an immediate capital gain to the shareholders would be avoided, with the added result that a larger fund would thereby be available for diversified investment; and if the liquidation should be postponed until the death of the shareholders, the capital gain might be eliminated entirely. \(^485\) The principal disadvantages lie in the fact that the sale by the corporation of its assets (if not followed by liquidation\(^486\)) would be a taxable transaction, and in the fact that the subsequent income would be subject to double taxation. \(^487\) The latter disadvantage, however, could be minimized considerably if the corporation concentrated its investments in shares of domestic corporations\(^488\) and if it retained, rather than distributed, any long term capital gains. \(^489\)

b. **Conversion to personal holding company after partial liquidation:** Where the circumstances of the shareholders vary widely, e.g. when some would have a large gain on a liquidation distribution and others little or none, or where some are aged and others are not, it may prove advisable for certain of the shareholders to stay in and for the others to get out. For those shareholders staying in, the same problems and advantages and disadvantages would be present as have been discussed in the preceding paragraph. For those shareholders wanting to get out, however, the problems would be entirely different. There would of course be no way to avoid the tax at the corporate level on the gain, if any, realized by the corporation on the sale of its business. \(^490\) The value of the corporate assets would thus be diluted by the amount of such tax and the value of the shares of the withdrawing shareholders would be reduced accordingly. Beyond that, however, the main problem of the withdrawing shareholders would be one of avoiding having their liquidation distribution being treated as a dividend to them. That problem is by no means peculiar to shareholders desiring to withdraw from a business which has sold its assets. As in other instances of withdrawing shareholders, the solution will most probably be found in the “disproportionate
TAX PROBLEMS OF CLOSE CORPORATIONS

tionate redemption" and "complete redemption" provisions of Section 302(b) which have been discussed elsewhere in this article.491

c. Conversion to real estate company: A substantial number of individuals having funds to invest look with favor on the real estate market. To those persons, the conversion of their company into a real estate company492 as opposed to liquidation offers a number of advantages. Here again, the capital gain tax which would be imposed if the company were liquidated is avoided. And, because the personal holding company penalty tax of 75%-85% does not apply to a corporation whose income from rents equals or exceeds 50% of its gross income,493 the corporation is under no pressure from that source to distribute its annual earnings. Thus, again, if the shareholders would have a disproportionately large capital gain tax to pay on distributions received in liquidation, particularly if they are of advanced age, they may well find that considerable tax savings would result from converting their corporation, after it has sold its assets, into a real estate company.

d. Election under Subchapter S: We mention here the newly enacted Subchapter S494 under which a qualified corporation may elect to be treated substantially as a partnership, only to point out that it will probably offer few advantages to the shareholders of a corporation which has sold its business. The election may not be effectively made by a corporation which "has gross receipts more than 20% of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities."495 Unless, therefore, the shareholders of the corporation would be willing to have the corporation engage in activities producing income of other types than those enumerated above, they would be required, if the double tax on earnings is to be avoided, to liquidate the corporation and incur the capital gain tax on the liquidation distribution.

2. One-Month Liquidations

In some special situations shareholders who are burdened by the double tax and who do not desire to incur the capital gain tax which would attend an ordinary liquidation may find relief in the one-month liquidation provisions of Section 333. If the strict liquidation rules and

491. Page 91, supra.
492. The term "real estate company" has no statutory recognition but is intended herein to refer to a corporation which would be a personal holding company under § 542 except for the fact that 50% or more of its gross income consists of rents. § 543(a) (7).
493. § 542 and § 543(a) (7).
494. § 1372, as added by Section 64 of Technical Amendments Act of 1958.
495. § 1372(e) (5).
other prerequisites to the applicability of that section are followed, the shareholders are required to treat their gain on the liquidation as dividends, but only to the extent of the earnings and profits of the corporation, and are required to treat as capital gain only so much of the remainder of their gain as is not in excess of the amount by which the assets received in the liquidation consists of money or securities acquired by the corporation after December 31, 1953. Therefore, if the corporation has little or no accumulated earnings and has as its principal asset or assets property (e.g. a building) which has greatly appreciated in value, the section offers attraction to those shareholders desiring to defer the capital gains tax which would normally attend an ordinary liquidation.

3. Saving Shareholder Taxes by Proper Valuation

The rule is that a shareholder in determining his gain or loss on liquidating distributions must value assets received in kind at their fair market value. Many times because of the number of varying factors that are used in determining such a value, the value can be fixed only within a range. There is a general tendency to use the low values in that range in valuing the assets distributed. This is often shortsighted. For example, the assets received by the shareholder may become inventory items in his hands, depending of course upon the nature of his individual business activities. To the extent that they do or may constitute that type of asset, the shareholder by the low valuation (and consequent immediate savings of capital gains tax) has set the stage for the realization by him of just that much more ordinary income when such assets are subsequently sold.

4. Avoiding Ordinary Income On Liquidation

Unpaid salary, unpaid interest, and similar items owing by the corporation to the shareholder constitute debts and, when paid, will constitute ordinary income to the shareholder. If he is the sole shareholder, however, or if there are other shareholders to whom similar debts are owed in equal proportion to their share holdings, he or they would re-

496. (a) Adoption of plan of liquidation, (b) distribution of all assets (less reasonable amount of cash set aside in good faith to meet contingent liabilities and expenses) in complete cancellation or redemption of all stock, (c) transfer of property under the liquidation within some one calendar month, (d) filing of written elections under Reg. § 1.333-3 by qualified electing shareholders.

497. § 333 (e).

498. Here again, if death occurs before the property is sold, the capital gain may be completely avoided in view of the step up in basis on death of the distributee. § 1014.
ceive no less dollar amount on liquidation (and it would be capital gain or loss rather than ordinary income) if such debts could be allowed to remain unpaid and the entire corporate assets distributed in exchange for the stock. In liquidation, however, distributions are first considered to have been paid on debts and only the balance is treated as paid in exchange for the stock. In at least one case the Tax Court has held that forgiveness of the debt by the shareholders did not accomplish the desired tax result. In that case, however, the forgiveness of the debt and the distribution were, in effect, simultaneous transactions. The same result should not follow in cases in which the forgiveness is accomplished considerably in advance of the liquidation and at a time when it is evident the debt constitutes an undue burden on the corporation, but the decision to liquidate has not yet been formulated. Once the steps of liquidation are set in motion, however, and regardless of the tax consultant's decision as to treatment of existing debt, there would seem to be very few instances in which tax considerations would favor continued accrual of salaries to shareholders or continued accrual of interest on indebtedness owed to them.

5. Collapsible Corporation Status

Prior to the enactment in 1950 of a section in the Internal Revenue Code dealing with the collapsible corporation an individual engaged in the business of constructing and selling buildings could form a corporation, transfer land to the corporation, build a building on the land and then, before the corporation had realized any income from the appreciated value of those assets, he could (a) sell his stock in the corporation or (b) liquidate the corporation, and, in either case, the gain realized by him would be capital gain. This practice has been limited, although not completely stopped, by the collapsible corporation section which provides that any corporation which is "formed or availed of principally" for the purpose of converting gain from ordinary income assets into capital gain is a "collapsible corporation," and that gain realized (a) from the sale or exchange of stock of such a corporation, (b) from a distribution in partial or complete liquidation of such a corporation, or (c) from a distribution made at a time when the corporation has no current or accumulated earnings or profits.

499. Irving R. Lewis, 19 T.C. 887 (1953). Note, however, that the forgiveness of the debt will generally increase the taxable income (or reduce the deficit) of the corporation. Quaere, whether this consequence can be avoided by contributing the debt to capital.
500. Now § 341.
501. The practice apparently originated in the motion picture industry, where a separate corporation was formed for the production of each motion picture.
(to the extent that such distribution would be considered as a capital gain), will be treated as ordinary income.\textsuperscript{502} There are, nevertheless, two important, but frequently overlooked, limitations on the applicability of the collapsible corporation law. The first is that the ordinary income rule will not apply in cases where the gain is realized more than three years after the completion of the manufacture, construction, production or purchase by the corporation of the "collapsible" property.\textsuperscript{503} The second limitation, and probably the one which is most frequently overlooked, is that the ordinary income rule does not apply to the gain unless more than 70\% thereof is attributable to gain realized from the "collapsible" property.\textsuperscript{504} In the majority of instances, therefore, in which shareholders are confronted with collapsible corporation status, the ordinary income penalty can be avoided if the shareholders will be patient or merely not too greedy.

VI. Conclusion

In recent decades we have witnessed ever increasing complexities in our tax laws as applied both generally to all taxpayers but most particularly to the close corporation. Thus, the general practitioner who serves his small corporate clients, often finds himself exposed to many of the intricacies generated by such tax laws — yet in the service of these clients he must make his way in an area so perplexing as to defy the most learned specialists. With this in mind we set forth our objectives to lay a foundation from which corporate tax problems could be recognized and which would serve as a starting point towards their early avoidance and/or subsequent solution. Now our cycle has been completed — we have observed general tax considerations in the conception and birth, the various stages of life and death and burial of the close corporation. It is hoped that in surveying such an extensive area our objectives have not been too ambitious and that we have succeeded to some extent in attaining our goals.

\textsuperscript{502} § 341(a).
\textsuperscript{503} § 341(d) (3).
\textsuperscript{504} § 341(e) (2).