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> *Pangloss was professor of metaphysicotheologico-cosmolonigology. He proved admirably that there is no effect without a cause, and that, in this best of all possible worlds, the Baron's castle was the most magnificent of castles, and his lady the best of all possible Baronesses.*
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> *"It is demonstrable," said he, "that things cannot be otherwise than as they are; for all being created for an end, all is necessarily for the best end. Observe, that the nose has been formed to bear spectacles, thus we have spectacles . . . Consequently they who assert that all is well have said a foolish thing, they should have said all is for the best."*
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> VOLTAIRE, CANDIDE

I. INTRODUCTION

While major emphasis will be placed upon the tax considerations involved in answering the question posed by the title, the broader problem is aptly stated in the familiar phrase, "Choice of Business Form."[1] It is not possible to consider this problem realistically without taking into account the context of the business and private law considerations which must enter into the decision, and may indeed be controlling over the tax factors. Therefore, the question, "When Will the Corporate Form Save Taxes?" will be discussed in the light of the full legal and business milieu.

We often think of this problem—choice of business form—as a legal one, and indeed in some sense it is. But the initial decision is a business one and not one made by the lawyer: whether the venture will comprise the efforts of a single individual as owner and also furnisher of capital, or whether it will be a joint venture (I use that

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1. For general discussions of this problem, see: ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES 56-214 (3d ed. 1958); Miller, *Choice of Form of Business Organization*, in LECTURES ON TAXATION OF BUSINESS ENTERPRISES (University of Michigan Law School 1952); Axelrad, *Choice of Form: Partnership, Corporation, or In-Between*, N.Y.U. 19TH INST. ON FED. TAX (1961); Hornberg, *Corporation or Partnership*, 3 J. OF MO. BAR 35 (1947); Lanigar, *Doing Business as Partnership or Corporation*, 99 J. ACCOUNTANCY 48 (1955); Lewis, McClure, & Schroeder, *Individual, Proprietorship, Corporation*, 23 J. OF BAR ASS'N OF KANSAS 333 (1955); Sarner, *Choosing the Form of Organization*, 8 KAN. L. REV. 522 (1960).

term without the legal connotation that usually attaches); whether it will be some kind of cooperative enterprise. Since most of us are not given all the gifts that are needed for successful business enterprise—we may have know-how and managerial ability, but not the money—a group effort is commonly encountered. Once it is decided that the effort is to be carried forward in some kind of cooperative arrangement, the real choice of business form is presented. Two major alternatives emerge—corporation or partnership. On the other side, while a single venturer often carries forward a business in proprietorship form, an alternative almost equally available to him is the possibility of going forward in the form of a corporation which might be called, if it were not for the special meaning the term has acquired in the history of corporate law, "a corporation sole."[2] A corporation all of whose shares are owned by a single individual may still be a viable legal entity, and while nominal incorporators may need to be multiple, they often have no contemplation of management or ownership in the enterprise, all of whose shares will come to be owned by a single person.[3] It appears then that the fundamental decision is whether or not the enterprise is going to be a single venture or a group effort. Once that has been resolved, then in each alternative there are only two choices of business form rather than the three that are usually recited. To the single venturer the realistic possibilities are a proprietorship or a corporation all of whose stock would be owned by one person. To the joint venturer or the cooperative enterprise the choice is twofold again, a partnership or a corporation. Observe, however, that a single venturer might for tax considerations choose to use a partnership in order to split income among the family;[4] so things are not as simple as they seem. Furthermore, a single venturer organized in corporate form who spreads stock ownership among the members of his family may achieve an even more reliable

2. "A corporation sole is one consisting of one person only, and his successors in some particular station, who are incorporated by law in order to give them some legal capacities and advantages, particularly that of perpetuity, which in their natural persons they could not have had. In this sense, the sovereign in England is a sole corporation, so is a bishop, so are some deans distinct from their several chapters, and so is every parson and vicar." BLACK, LAW DICTIONARY 274 (2d ed. 1910).

3. O'NEAL, CLOSE CORPORATIONS § 1.05 (1958), contains an interesting and concise discussion of one-man corporations, with comprehensive references to cases, statutes, and law review articles.

4. INT. REV. CODE OF 1954, § 704(e). Regarding family partnerships, see Minn. 6767, 1952-1 CUM. BULL. 111; Berman & Berman, *Partnership or Corporation? Possible Tax Savings under the 1951 Revenue Act*, 57 DICK L. REV. 208 (1953); McClain, *Family Partnership v. Corporation-Income Tax Aspects*, 2 VAND. L. REV. 231 (1949) (excellent discussion pre-dating the Revenue Act of 1951 which added the predecessor of § 704(e); White, *Taxation of the Family Farm Corporation & Partnership: Variations on a Theme*, 36 N.D.L. REV. 87 (1960); Note, 61 YALE L.J. 541 (1952).
Act of 1951, 61 YALE L.J. 541 (1952).

method of dividing income, thereby keeping more in lower tax brackets.[5]

II. Private Law Advantages of the Corporate Form

Let us canvass very briefly the private law advantages that the corporate form confers. They are all connected with the rise of the modern business corporation as a major instrumentality of the capitalistic system.[6] A large enterprise that required an aggregation of capital also demanded the legal characteristics that have come to be given to the corporate form. Each of them clearly is connected with the function of a corporation as a large capital gathering mechanism, making possible ventures that no single person could undertake, or would wisely undertake if his personal and business estate were at risk. In other words, the characteristics of corporate form that the law confers derive largely from the needs of big business. Yet, of course, they are not restricted to big business but are, under our modern general corporation laws, available to a very small business owned by a small number of people or even by only one.

What are the chief characteristics that are conferred by corporate existence?[7] First and foremost is limited liability, which the British denote when they designate their corporations as "Ltd." In the case of a close corporation whose shareholders frequently must pledge their own credit to back up corporate borrowing, one might question how far this feature is illusory. Two observations will suffice to demonstrate that limited liability is not totally illusory even to the close corporation. In the first place, general creditors on trade accounts and wages are not able to reach the assets of the investors but are limited to the amount of the corporation's capital. Secondly, tort liability, which is even a more serious risk, can be buffered by the existence of a corporation. Is insurance an adequate answer to that? One Tax Court judge remarked a few years ago that this risk could be covered by insurance so that the multiple corporations in that particular case were not justified.[8] But little experience is required for one to appreciate how limited is the protection that insur-

5. *But, cf.* Overton v. Commissioner, 162 F.2d 155 (2d Cir. 1947).

6. For an excellent historical summary, see 1 Dodd & Baker, Cases on Business Associations: Corporations 1-37 (1940).

7. Treas. Reg. § 301.7701-2 (1960), as amended, T.D. 6797, 1965 Int. Rev. Bull. No. 9, at 38 (1965), contains an excellent, although in some areas controversial, analysis of corporate characteristics. See also Morrissey v. Commissioner, 296 U.S. 344 (1935).

8. Aldon Homes, Inc., 33 T.C. 582, 598 (1959). The court observed that the investors already had one corporate shield and questioned whether their multiplication was really motivated by the reasons advanced or by the desire to achieve multiple surtax exemptions.

ance affords. Certainly it is true that liability insurance is needed. Every corporation (and every partnership) would want to have it. But to say that it would be an answer to the problem of limited liability and thereby make the partnership equally attractive is certainly unrealistic. Not only may the coverage of the policy not extend to the particular risk from which loss arises, but the monetary limits on the policy may cause protection to fail when it is needed the most.[9] Therefore, even in the case of close-held corporations, while limited liability may not be quite so limited as it first appears to be, it is still a significant factor that must weigh heavily in the balance when choosing between the corporation and the partnership or proprietorship.

Next is free transferability of interests. This characteristic makes it possible for an investor to gain a shift in his investment, to recoup his investment really, without having to destroy the venture that is going forward. He simply lets someone else take over and stand in his shoes. From the viewpoint of our industrial economy this feature serves to enhance mobility of capital. But the fact is that the shareholds of close corporations do not want this particular feature. This one above all is shunned. The typical pattern involves a congenial group, perhaps all related to each other, who do not wish to admit a stranger within the gate. Much legal effort is expended in designing and implementing buy-sell restrictions that effectively keep the shares from being freely transferable—the "first offer" and "first refusal" arrangements.[10] Closely held enterprises would not choose the corporate form for this feature, unless the organizers desired access to the capital market through a public offering of stock. Since this generally undesirable incident of corporate form can be effectively limited by contractual restrictions (often wisely incorporated into the articles of incorporation or by-laws) free transferability of interests may be considered a neutral factor in the choice of form for closely held enterprises.

The third corporate characteristic is centralized management, which serves to accomplish the separation of ownership from management.

9. Consider the hypothetical case of a truck which collides with a school bus full of children, or a limousine carrying six $100,000 per year executives, used by Professor Hartman in an address before the Tennessee Oil Men's Association. Address by Professor Paul J. Hartman, Tennessee Oil Men's Ass'n, Nov. 19, 1963.

10. O'NEAL, *op. cit. supra* note 3, at 2-80; Barron, *Validity and Enforcement of Various Types of Restrictions on Share Transfer and Buy-Out Arrangements in Ohio*, 31 U. CINC. L. REV. 266 (1962). BICKEL, *Keeping a Close Corporation Close*, 23 Ohio Bar 537 (1960); O'NEAL, *Restrictions on Transfer of Stock in Closely-Held Corporations*, 65 HARV. L. REV. 773 (1952). For a general discussion of the tax problems involved, see Strecker, *Corporate Buy-Sell Agreements: Tax Problems in Drafting*, 15 WASH. & LEE L. REV. 18 (1958), reprinted as a tax classic in 9 TAX COUNS. Q. 325 (1965).

In the case of many close corporations this is totally inappropriate. These entrepreneurs want to unite ownership and management because they all intend to be active in the business. However, this does not characterize all close corporations. Many families own businesses in which only a few members are active. And here the corporation serves a very benign purpose in making it possible for the inactive family members, say the son who decides to become a doctor instead of going into his father's business, to continue owning an interest in the business while control may be vested in the other brother who decided to follow father's footsteps. So centralized management, while often inappropriate, is sometimes a positive factor and could in a certain type of case make the corporate form attractive. But typically this feature, like free transferability, is neutral and holds no charm for the closely held enterprise.

The fourth corporate characteristic, continuity of life, is closely allied with the fictional nature of corporate existence. A corporation continues to exist, in contemplation of law (the only sense in which a legal corporation, as distinct from a socio-economic entity known as an "enterprise," can exist), despite the death or withdrawal of any of its officers, directors, shareholders, or employees. By way of contrast, a partnership is technically dissolved by operation of law upon the death or withdrawal of any partner. The continuity of corporate life seems to impart a stability and continuing vitality to the enterprise. It should be observed that to some extent the continuity of corporate existence may be a self-validating hypothesis—if we believe it will tend to become true. But while corporate form may facilitate continuity of the enterprise, those who have counselled close corporations realize that the corporate form does not guarantee the *sine qua non* of actual continuity of the business—adequate management succession.[11] Continuity of successful operation is a much more elusive thing than can be achieved by putting words on paper and calling it a corporate charter. Also it is true that a partnership agreement under modern law can give a degree of continuity of life, though perhaps somewhat more limited.[12] And indeed, as Professor O'Neal points out in his study of the "squeeze out" of minority interests in close corporations, continuity of life may even be a disadvantage from the standpoint of a minority investor.[13] One representing a person who is going into a venture as a minor shareholder might very well advise him to go in as a minor

11. See Lawthers, *The Fraigle Bark of the Small Corporation*, 7 J. AM. SOC'Y C.L.U. 4 (1957).

12. UNIFORM PARTNERSHIP ACT §§ 31, 40-42.

13. O'NEAL, EXPULSION OF OPPRESSION OF BUSINESS ASSOCIATES; "SQUEEZE-OUTS" IN SMALL ENTERPRISES (1961).

partner, because a partner can pull out his investment any time he wishes by a voluntary dissolution.[14] A minority shareholder is locked in and may be subject to abuse, such as overly conservative dividend policy designed to discourage him from continuing as a shareholder, perhaps driving down the value of the stock so that it can be purchased by the majority shareholders at a bargain. This typical squeeze-out situation is illustrative of the many varieties of what one reviewer called "man's inhumanity to man" detailed in O'Neal's work.

When we appraise the considerations involved we find that with some qualification, the only corporate characteristic of true importance for the closely held enterprise is limited liability. The matter becomes more simple than at first it had appeared to be. Free transferability, generally not desired, can be neutralized. Centralization of management is desirable only in selected cases, but in most cases forces what is really a partnership or proprietorship to adopt cumbersome procedures and/or empty paper work for fear of jeopardizing limited liability. Continuity of life may help to facilitate continuity of the enterprise, but must not be allowed to lull the investors into complacent disregard of the very practical problem of insuring adequate management succession.

There are some other non-tax legal compulsions or inducements to the selection of a particular form of doing business. One, a consequential business advantage resulting from all these corporate characteristics, is improved ability to raise capital. Public sale of stock is possible and borrowing, whether from individual investors or from financial institutions, may be facilitated. The strict limitations placed by the corporate law on the withdrawal of funds by shareholders assure creditors that at least the amount of stated capital will be available as a cushion to protect them against loss. And if shareholders do impair the capital, creditors know that they may recover the illegal dividends from the shareholder-recipients,[15] or perhaps the directors.[16]

14. See note 12 *supra*.

15. Stockholders may not be liable for innocently acquired dividends if they were paid out when the corporation was solvent. Bartlett v. Smith, 162 Md. 478, 160 Atl. 440, 161 Atl. 509 (1932). For statutes dealing with shareholder liability, see CAL. CORP. CODE § 1510 (requirement of scienter); MICH. STAT. ANN. § 21.48 (1963); OHIO REV. CODE § 1701.95(c) (shareholder must have knowingly received them). See LATTIN, CORPORATIONS 492 (1959). Compare N.Y. STOCK CORP. LAW § 114, which holds stockholders of a foreign corporation doing business in New York liable for unauthorized dividends; Irving Trust Co. v. Maryland Cas. Co., 83 F.2d 168 (2d Cir. 1936), applies the latter New York law to a transferee of a Delaware corporation.

16. For a director's liability under the common law, see Burke v. Marlboro Awning Co., 330 Mass. 294, 113 N.E.2d 222 (1953). For statutes dealing with director's liability, see CAL. CORP. CODE § 825; N.Y. STOCK CORP. LAW § 58 (director not

Legal compulsion is illustrated by the familiar case of the doctor or lawyer who is precluded by state law and ethical considerations from use of the corporate form.[17] Recent state legislation authorizing formation of professional associations or corporations has made considerable inroads on this traditional taboo.[18]

III. ADVANTAGES OF PARTNERSHIPS

What advantages does the partnership possess? A prevailing opinion seems to be that it is less expensive to form a partnership than a corporation. Since the major element of expense is the attorney's fee, this might vary from one part of the country to another. But to the extent that the attorney's fee is based on time, effort, and skill required, a conscientious lawyer might well feel that he should charge as much (or more) for a complex partnership agreement as he would for a fairly well standardized corporate formation. And if tax considerations are given their due share of attention, there is some evidence that more difficulty will be encountered in counselling on the less familiar but not less complex tax problems in drafting partnership agreements.[19]

What tax advantages does a partnership offer? A minor one is that the partnership is a more perfect conduit, not changing the tax character of the income which passes through it.[20] Thus, tax-exempt

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liable if reasonably believed dividend distribution would not impair capital); OHIO REV. CODE §§ 1701.33-.95(A) (1964); TENN. CODE ANN. §§ 48-123 to -212 (1964) (director not liable if in good faith relied on balance sheet and other accounting means of corporation). See BAKER & CARY, CASES AND MATERIALS ON CORPORATIONS 619-25 (3d ed. 1959); LATTIN, CORPORATIONS 490 (1959).

17. The Ohio Supreme Court has held the Ohio Professional Association Act unconstitutional insofar as it attempted to authorize the practice of law in contravention to rule XIV of that court's rules of practice, which permits only natural persons to be admitted to practice. State *ex rel.* Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962); Note, 31 U. CINC. L. REV. 341 (1962).

18. A recent count indicated that 33 states had adopted legislation designed to permit the formation of professional associations or corporations to carry on various professional callings. See Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments,* 17 TAX L. REV. 1 (1961); Ebner, *Pros and Cons of Professional Association Acts,* 15 J. TAXATION 308 (1961); Grayk, *Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments,* 17 TAX L. REV. 469 (1962); Maier, *Don't Confuse Kintner-Type Associations With New Professional Corporations,* 15 J. TAXATION 248 (1961); Scallen, *Federal Income Taxation of Professional Associations and Corporations,* 49 MINN. L. REV. 603 (1965); Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees, and Quasi-Tax Relief for Professional Persons,* 48 CORNELL L.Q. 613 (1963).

19. WILLIS, PARTNERSHIP TAXATION (1957); Willis, *Drafting Partnership Agreements: the General Lawyer's Responsibility for Income Tax Consequences under the Internal Revenue Code of 1954,* 16 MONT. L. REV. 44 (1955); 26 PA. BAR ASS'N Q. 185 (1955); 9 WYO. L.J. 106 (1955).

20. Caplin, *Partnership or S Corporation? A Check List of the Tax Factors in the Choice,* 12 J. TAXATION 32 (1960).

municiple bond interest or tax-favored long-term capital gains received by a partner will still retain their original indentity.[21] These same items received by a corporation increase its "earnings and profits" and will ordinarily be treated as dividend income, taxable at ordinary rates, when distributed to the shareholders.[22] Subchapter S treatment goes some distance, but not all the way, toward equalizing the postion of partners and shareholders with respect to the pass-through of items having a special and favorable tax status at the entity level.[23]

The tax laws of many states impose franchise and/or income taxes on corporations only, which of course are avoided by use of the partnership form. Since these taxes are usually not high, this may be considered a minor tax advantage.[24]

A major tax advantage of the partnership is involved in what might be called "loss planning." Those counselling the investors in prospective business ventures have a unique opportunity and responsibility to lend objective judgment as to the likelihood of success. The investors have spent weeks or months persuading themselves that the venture will be profitable. Not that counsel should be pessimistic; too much of that may persuade the investors that their attorney is representing the other side and they may seek other advice. But counsel owes it to his client to point out the possibility (however remote) that the venture will fail and the investment, or part of it, will be lost. If planning will permit the loss to be recognized for tax purposes in the most favorable way, the risk of loss is somewhat buffered and the transaction becomes a better bet. While obviously loss planning will never supersede planning for profit, insofar as it can be done without jeopardizing other more important objectives, it should be given due consideration.

What is favorable loss treatment? There are three criteria, each of which is illustrated by an example. Ideally, the deduction should be (1) certain, (2) favorably treated, and (3) early. Uncertainty surrounds the future deductibility of a corporate net operating loss carryback or carryforward, since if the corporation never becomes

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21. INT. REV. CODE OF 1954, § 702.

22. Treas. Reg. § 1.312-6 (1955).

23. Caplin, *supra* note 20; Lourie, *Subchapter S After Six Years of Operation: An Analysis of Its Advantages and Defects*, 22 J. TAXATION 166 (1965).

24. MICH. STAT. ANN. § 21.205 (1963) ("five mills upon each dollar of its paid-up capital and surplus . . . ."); N.Y. TAX LAW § 210 (Supp. 1965) ("computed at rate of four and one-half per centum on its entire net income . . . or (2) computed at one mill for each dollar of its total business and investment capital . . . ."); PA. STAT. ANN. tit. 72, § 1871 (a)-(b) (Snpp. 1964) ("five mills upon each dollar of the actual valne of its whole capital stock of all kinds . . ."). For comparison of rates of corporate income tax, see Special Snbcommittee on State Taxation of Interstate Commerce of the House Committee on the Jndiciary, *State Taxation of Interstate Commerce*, H.R. REP. No. 1480, 88th Cong., 2d Sess. 105-07 (1964).

profitable, there will be no income against which the loss can be offset.[25] And if a corporation ceases business after several years of losses, the benefit of that tax history cannot, generally, be passed on to others.[26] Also, any benefit is postponed until profit appears at the corporate level.

Deduction of the shareholder's loss on his investment is postponed until the year he sells the shares at a loss or until the year in which the stock became worthless.[27] Disputes frequently arise over the proper year, and deduction in too late a year can lead to forfeiting the deduction since the period of limitations on refunds may have elapsed.[28] Even when deduction is taken, it yields the limited benefit accorded capital losses, and can only be offset against capital gains (if any); otherwise only 1,000 dollars per year will be deducted from ordinary income, with a carryover for an indefinite number of years.[29] While section 1244 allows ordinary loss treatment on the sale or worthlessness of "small business corporation stock" within strict dollar limitations, the deduction is still postponed until the year of sale or worthlessness. The use of debt in the capital structure might in exceptional cases permit deduction against ordinary income as a "business bad debt," but generally the worthless debt will yield capital loss merely.[30] In addition, this capital loss is postponed until the year of worthlessness.[31] The choice of corporate form (absent election under subchapter S)[32] offers a cheerless prospect from the standpoint of loss planning.

A partnership net operating loss passes through to be deducted on the partners' returns almost as the loss is being incurred, and against ordinary income to boot.[33] Loss is given tax recognition sooner, more surely, and more favorably than the investors in the incorporated venture.

A final tax advantage of the partnership might tip the scales in a doubtful case. Taxwise, formation of a partnership is less of a commitment than formation of a corporation. While the formation

25. INT. REV. CODE OF 1954, § 172.

26. INT. REV. CODE OF 1954, §§ 269, 381-82, 482.

27. INT. REV. CODE OF 1954, § 165 (particularly subsection).

28. Ainsley Corp. v. Commissioner, 332 F.2d 555 (9th Cir. 1964); Industrial Rayon Corp. v. Commissioner, 94 F.2d 383 (6th Cir. 1938); Fairbanks, Morse & Co. v. Harrison, 63 F. Supp. 495 (N.D. Ill. 1945); 5 MERTENS, FEDERAL INCOME TAXATION § 26.97 (rev. ed. 1963); Comment, 18 VAND. L. REV. 814 (1965). Section 6511(d)(1) of the Code provides an extended (7 year) period of limitations on refunds based on bad debts and worthless securities.

29. INT. REV. CODE OF 1954, §§ 1211-12.

30. INT. REV. CODE OF 1954, § 166; Whipple v. Commissioner, 373 U.S. 193 (1963).

31. INT. REV. CODE OF 1954, § 166.

32. INT. REV. CODE OF 1954, §§ 1371-77. See also text accompanying notes 114-124 *infra*.

33. INT. REV. CODE OF 1954, § 702.

of either a partnership or a corporation is generally nontaxable,[34] the liquidation of a corporation,[35] unlike the liquidation of a partnership,[36] is normally a taxable event. Thus, if a corporation is formed and it is later decided that a partnership would serve the parties' needs better, tax may be incurred on gains accruing over many years (even before the corporate formation) by reason of the corporate liquidation incident to switching to partnership form. On the other hand, if a partnership is formed at first, and later converted into a corporation, no tax will ordinarily be incurred upon the partnership liquidation incident to formation of the new corporation. And since loss may be more likely in the first years, initial choice of a partnership would be supported by early, certain and favorable treatment of loss.

IV. Minor Tax Advantages of the Corporate Form

The numerous minor (but not unimportant) tax advantages of the corporate form arise from the fact that shareholders of a corporation can also be employees of the corporation, while neither partners nor sole proprietors can qualify as employees of their partnership or proprietorship.[37] They are, of course, self-employed. The many so-called fringe benefits are available only to employees. The term "fringe benefits," however, is ambiguous and includes two distinct types of tax benefits which are extended to employees. One class, which might be denominated "nontaxable compensation" comprises numerous special economic benefits which may be given to employees without any resulting tax burden, immediate or future. The other class of fringe benefits is "deferred compensation," in a broad sense including any arrangement whereby the tax upon employee benefits is postponed until a taxable year later—sometimes many years later than the year in which the services were rendered.

A. *Nontaxable Compensation*

The following are the more commonly encountered items of nontaxable compensation.

1. *Meals and Lodging.*—If furnished for the convenience of the employer, as in the case of a hotel manager who must remain on call

34. INT. REV. CODE OF 1954, §§ 351, 721 (corporations and partnerships, respectively).

35. INT. REV. CODE OF 1954, § 331.

36. INT. REV. CODE OF 1954, § 731.

37. See G.C.M. 6582, VIII-2 CUM. BULL. 200 (1929).

at all times, the value of meals and lodging is excluded from gross income for tax purposes.[38]

2. *Moving Expense.*—Prior to 1964 the case law had established exclusion of reimbursement for direct moving expenses of an employee who remained with the same employer.[39] Doubt surrounded incidental items such as reimbursement for real estate commission and for loss on sale of personal residence, the courts tending to hold such reimbursements taxable compensation.[40] And all expense reimbursements, even those for direct moving costs, were taxable to the employee who changed employers as well as location.[41] The Revenue Act of 1964 erased this latter distinction and made specifically excludable if reimbursed, and deductible if not reimbursed, the direct moving costs of employees, even those who do not remain with the same employer.[42]

3. *Group Term Life Insurance.*—The regulations have for many years allowed an employer to furnish group term life insurance protection without requiring the employee to pay tax on the value of this coverage.[43] Abuse was said to have arisen where very high-salaried executives were given coverage ranging into six figures. The Revenue Act of 1964 limited to 50,000 dollars the amount of coverage for any individual which can qualify for exclusion in the future. The cost of providing coverage in excess of that amount will be taxable compensation.[44]

4. *Split-Dollar Life Insurance.*—Beginning in 1955, the Internal Revenue Service ruled that no income to an employee would result from provision of insurance coverage under the "split-dollar" ar-

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38. INT. REV. CODE OF 1954, § 119; Arthur Benaglia, 36 B.T.A. 838 (1937), *appeal dismissed,* 97 F.2d 996 (9th Cir. 1938).

39. Rev. Rul. 54-429, 1954-2 CUM. BULL. 53; S. REP. No. 830, 88th Cong., 2d Sess. 71-73 (1964). A decision by the Tax Court permitting deduction of unreimbursed moving expenses has recently been reversed. Commissioner v. Mendel, P-H AM. FED. TAX REP. 2d 5796 (4th Cir. 1965), *reversing* Walter H. Mendel, 41 T.C. 32 (1963).

40. Bradley v. Commissioner, 324 F.2d 610 (4th Cir. 1963), *affirming* Harris W. Bradley, 39 T.C. 652 (1963), *overruling* Otto Sorg Schairer, 9 T.C. 549 (1947). In *Bradley,* the court found that payment made by the employer in reimbursing an *old* employee for loss incurred on the sale of his residence, after the employee's move to the new employment site, was additional compensation and taxable. In Arthur J. Kobacker, 37 T.C. 882 (1962), it was held even before the Tax Court overruled *Schairer* that this was taxable income for a *new* employee who was reimbursed for moving to his new employment site. England v. United States, 345 F.2d 414 (7th Cir. 1965) petition for *cert.* filed, 34 U.S.L. WEEK 3091 (U.S. Sept. 23, 1965); Willis B. Ferebee, 39 T.C. 801 (1963) (reimbursed real estate commission taxable). Rev. Rul. 64-153, 1964-1 CUM. BULL. 70.

41. Koons v. United States, 315 F.2d 542 (9th Cir. 1963); Willis B. Ferebee, 39 T.C. 801 (1963); see Finance Committee Report, *supra* note 39.

42. INT. REV. CODE OF 1954, § 217.

43. Treas. Reg. § 1.61-2(d)(2) (1963).

44. INT. REV. CODE OF 1954, § 79.

rangement.[45] Essentially the plan involves the joint ownership by the employer and the employee of a policy on the life of the employee. The employer owns the amount representing the cash surrender value, and the employee's named beneficiaries have the right to the balance, representing interest and the mortality gain. The employer and employee also contribute to the premium cost in the same proportion. That is, the employer pays an amount equal to the annual increase in the cash surrender value, and the employee pays the balance. This arrangement may make available a large amount of insurance coverage at very moderate cost, although as time goes by, the advantage recedes. The reasoning of the Service was that while the employee received an economic advantage, it was analogous to the employer lending money to the employee without charging interest, a transaction not thought to give rise to realized income.[46] While no reference was made to *Eisner v. Macomber*,[47] the constitutional requirement of "realization," stemming from that decision, might not be met in this transaction. The analogy to an interest-free loan arises since the insurance company's possession of the employer's funds representing the cash surrender value enables it to earn income which helps reduce the premium cost.

Among the recommendations for tax revision proposed by Treasury Secretary Dillon in 1963 was the suggestion that the economic advantage conferred upon the employee should be included in taxable income.[48] While Congress did not adopt this recommendation, the Internal Revenue Service has recently announced revocation of the favorable 1955 ruling, its position now being similar to that advocated by Secretary Dillon. For policies purchased after November 13, 1964, the employee must include in income the value of the insurance protection afforded in excess of premiums paid by him.[49] The approach is essentially the "economic benefit" theory which has been employed previously to tax pre-paid annuity contracts furnished to employees.[50] The new ruling holds that the arrangement is not essentially similar to an interest-free loan, as at first believed.

45. Rev. Rul. 55-713, 1955-2 Cum. Bull. 23.

46. J. Simpson Dean, 35 T.C. 1083 (1963); Smith-Bridgman Company, 16 T.C. 287 (1951); Rev. Rul. 55-713, *supra* note 45. *But see* Proposed Treas. Reg. § 482, 30 Fed. Reg. 4256 (1965), attributing interest to the borrower in transactions between related trades or business.

47. 252 U.S. 189 (1920).

48. The proposal was that "the earnings on the employer's cash surrender value which are applied to purchase insurance protection for the employee would be taxable to the employee as additional compensation." *Hearings before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 112-13 (1963).

49. Rev. Rul. 64-328, 1964-2 Cum. Bull. 11.

50. United States v. Drescher, 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950); Renton K. Brodie, 1 T.C. 275 (1942).

In determining the value of the insurance protection provided, apparently reference will be made to the cost of term insurance in the amount of the coverage afforded the employee. Since the employee actually is purchasing a policy of permanent insurance (although he cannot receive the cash surrender value) the actual economic value of the benefit may exceed the tax value, so that there is a residual advantage in the continued use of this device even under the recent Treasury ruling. Furthermore, there is much to be said in favor of the original analogy to an interest-free loan, despite the Service's change of position. Some courts may eventually show their preference for this analysis, particularly since there is more than a hint of a constitutional issue involved. It might be felt that Congress, and not the Treasury Department (even though the House Committee remitted the question to the Treasury Department for further study and possible administrative action)[51] should make such a bold inroad on the realization doctrine.

On the other hand, it is clear that the Supreme Court is willing to find realization where it otherwise would not be found, when the special relationship of employer-employee exists. The leading case to this effect is *Commissioner v. LoBue*,[52] where the Court held that while a bargain purchase of property does not usually give rise to realized income, purchase of the employer's stock at a price below its fair market value could be realized income as a form of compensation. And apparently, no subjective inquiry is to preclude such characterization. If an employee purchases property from his employer at a bargain price, compensation characterization will be inferred. Recitals that the purpose was to give the employee a proprietary interest in the employer-corporation in order to ensure industry and loyalty, formerly effective to rebut the compensation characterization, were not given effect.

Even when the Treasury Department was ruling favorably on split-dollar arrangements generally, it was widely reported that such ruling would be withheld in the case of an employee who was also a shareholder, the typical close-corporation situation. The reasoning behind this is difficult to fathom, since it would seem that there is no more basis for arguing that realization occurs when a corporation confers an economic benefit upon a shareholder (dividend) than when an employer confers an economic benefit upon an employee (compensa-

51. H.R. REP. No. 749, 88th Cong., 1st Sess. 62 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 78 (1964). "Your Committee believed that the issues involved in this problem, and the proper solution, including the possibility of administrative action, are in need of further study by the Treasury Department."

52. 351 U.S. 243 (1956). For a comparison of this case with Commissioner v. Duberstein, 363 U.S. 278 (1960), see note 74 *infra*.

tion). Perhaps the availability of two strings to its bow explains the Treasury Department's reluctance to extend what now is regarded as an overly generous ruling.

In view of the doubts which might be entertained as to the correctness of the Treasury's position as a matter of law, and also taking into view the residual advantage even under the 1964 ruling, split-dollar arrangements will continue to be used, at least until their legal status is clarified by court decisions. Appraising the risk overall, some will feel that continued use of the device may not be worthwhile since it is sure to be challenged and may lead to expensive litigation.

5. *Interest-Free Loans.*—Whatever the status of split-dollar life insurance, there is much support for the position that no income is realized by an employee who is allowed the use of funds belonging to his employer without being required to pay interest.[53] Undeniably there is an economic benefit which might be measured by the prevailing rate of interest charged by financial institutions on loans involving similar risk. And the Revenue Act of 1964 establishes a precedent for taxation of disguised interest in deferred payment transactions on which no "interest" is charged.[54] But the Tax Court has upheld the nontaxability of an interest-free loan made be a close corporation to its shareholders,[55] and the constitutional requirement of realization may also be cited in support of the same conclusion.[56] One reason why the courts are reluctant to find imputed interest to the borrower is the paradox that the lender may also be alleged to have imputed income equal to the interest he should have received.[57] While the Service has revoked its favorable 1955 ruling on split-dollar insurance, the reasoning rejects the analogy to interest-free loans, not the underlying premise that interest-free loans are nontaxable. On the question whether realization occurs, see the preceding discussion of split-dollar insurance.

6. *Sick Pay.*—Pursuant to President Eisenhower's recommendation, Congress in 1954 adopted the policy of excluding from an employee's gross income an amount, not exceeding a rate of 100 dollars per week, paid by the employer during the employee's illness.[58] Amounts paid during the first seven days of illness were taxable unless the

53. See note 46, *supra* and accompanying text.
54. INT. REV. CODE OF 1954, § 483.
55. J. Simpson Dean, *supra* note 46.
56. Eisner v. Macomber, *supra* note 47.
57. The contention was rejected in Brandtjen & Kluge, Inc., 34 T.C. 416 (1960); Society Brand Clothes, Inc., 18 T.C. 304 (1952); and in Combs Lumber Co., 41 B.T.A. 339 (1940).
58. INT. REV. CODE OF 1954, § 105(d).

employee were hospitalized or had suffered personal injuries. President Kennedy in 1963 recommended repeal of this exclusion.[59] Congress' decision was to restrict it somewhat more, but to retain the essential provision. During the first thirty days of absence from work, the payments must not exceed seventy-five per cent of the regular weekly rate. Also, the former seven day waiting period is continued. One difficult question has been the extent to which a "plan" is needed, and what degree of formality of communication is required to establish a "plan."[60] Also, where one retires early due to sickness or injury, some part of the pension received may qualify as "sick pay."[61]

7. *Medical Insurance and Reimbursement.*—It has been suggested that use of the corporate form may permit circumvention of the present limitations on deductibility of medical expense.[62] The reasoning is that the corporation is permitted to deduct, and the employee need not report as income, the cost of medical insurance furnished to the employee, or the amounts which represent reimbursement of medical expense incurred by the employee, his spouse and dependents.[63] Exclusion is the same in effect as deduction, and the 3 per cent of adjusted gross income "floor" which applies to medical expense deductions by individual taxpayers[64] is not encountered. Similar questions as to the need for a "plan" may arise here as in the case of sick pay.

8. *Employee Death Benefits.*—For many years it has been customary for close corporations and others to make some kind of payment to the widow or other heirs of deceased former employees. Among other things, continuation of the salary, or a portion of it, for a year or two, has been quite common. The tax status of these payments, both to the recipient and to the payor, has had a checkered history.[65]

59. *Hearings before the House Committee on Ways and Means, supra* note 48, at 20.

60. Treas. Reg. § 1.105-5 (1964); John C. Lang, 41 T.C. 352 (1963), 17 VAND. L. REV. 1549 (1964); Chism v. Commissioner, 322 F.2d 956 (9th Cir. 1963). *But see* Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965); Andress v. United States, 198 F. Supp. 371 (N.D. Ohio 1961).

61. Commissioners v. Winter, 303 F.2d 150 (3d Cir. 1962). Compare Corkum v. United States, 204 F. Supp. 471 (D. Mass. 1962).

62. Note, 33 ST. JOHN'S L. REV. 187, 204 (1958).

63. INT. REV. CODE OF 1954, § 105.

64. INT. REV. CODE OF 1954, § 213.

65. Calechman, *Recent Payments-to-Widows Cases Stress Facts,* 14 J. TAXATION 308 (1961); Crown, *Payments to Corporate Executives' Widows,* N.Y.U. 19TH INST. ON FED. TAX. 815 (1961); Diehl, *Payments to Widows of Corporate Employees,* 1960 So. CALIF. TAX INST. 491; Getz, *Payments to Widow Not Taxed in First 1954 Code Case,* 11 J. TAXATION 229 (1959); Gewanter, *Employee Death Benefits,* N.Y.U. 21ST INST. ON FED TAX 523 (1963); Griswold, *Of Time and Attitudes,* 74 HARV. L. REV. 81, 88 (1960); Yohlin, *Payments to Widows of Employees,* 40 TAXES 208 (1962) (excellent

At one time, the Service took the view that since the payments were made to one who had rendered no service to the payor, they were not compensation.[66] And within reasonable limits as to duration and amount, the theoretically inconsistent deduction was also permitted.[67] In 1950, the Service reviewed its former position and reversed itself. Since the payments would not have been made were it not for the former rendition of services, they are compensation even though remitted to another than the person who earned them.[68] Shortly thereafter, in the Revenue Act of 1951, Congress was persuaded that the analogy to life insurance should render these payments, within dollar limits, nontaxable.[69] They are somewhat like self-insured life insurance, the employer carrying the risk himself rather than funding it. The limit selected was 5,000 dollars but inadvertent wording permitted the result that if one had more than one employer, multiple exclusions would be available. In the revenue revision which led to the enactment of section 101(b) of the 1954 Code, the 5,000 dollar exclusion was clearly limited to one per employee, and the requirement of a "contract" was deleted. In the meanwhile, many taxpayers were vigorously contesting the Service's change of position, asserting in numerous litigated cases that the payments were made out of concern for the widow's welfare and motivated by affection for her—excludable under section 102 as gifts.[70] Taxpayer success in this area was mixed. Numerous lower courts were receptive,[71] though not so the Tax Court.[72] A number of appellate

recapitulation); Note, 17 J. TAXATION 228 (1962); Note, 49 KY. L.J. 531 (1961); Note, 27 TENN. L. REV. 314 (1960).

66. I.T. 3329, 1939-2 CUM. BULL. 153.

67. See Income Tax Reg. 118, § 39.23(a)-9 (1953), for the formulation in effect immediately before the 1954 Code. It is said that this position was taken in the regulations since the Revenue Act of 1918. McLaughlin Gormley King Co., 11 T.C. 569 (1948). Under the 1954 Code, the statement is found in Income Tax Reg. § 1.404(a)-12 (1956).

68. I.T. 4027, 1950-1 CUM. BULL. 9, *revoking* I.T. 3329, 1939-2 CUM. BULL. 153.

69. Int. Rev. Code of 1939 § 22(b)(1(B), as amended, ch. 521, 65 Stat. 452 (1951) (now INT. REV. CODE OF 1954 § 101(b). See Nelson, *New $5,000 Death Benefit*, 31 TAXES 629 (1953).

70. Bounds v. United States, 262 F.2d 876 (4th Cir. 1958); Rodner v. United States, 149 F. Supp. 233 (S.D.N.Y. 1957).

71. Fanning v. Conley, 65-1 CCH U.S. Tax Cas. ¶ 9404 (D. Conn. 1965); Peters v. United States, 63-2 CCH U.S. Tax Cas. ¶ 9512 (D. Minn. 1963); Schleyer v. United States, 63-2 CCH U.S. Tax Cas. ¶ 9539 (E.D. Mo. 1963); Corasaniti v. United States, 212 F. Supp. 229 (D. Md. 1962); Taylor v. United States, 62-2 CCH U.S. Tax Cas. ¶ 9828 (E.D. Tenn. 1962); Vaughn v. United States, 62-2 CCH U.S. Tax Cas. ¶ 9688 (S.D. Ga. 1962); Schwartz v. United States, 62-2 CCH U.S. Tax Cas. ¶ 9661 (N.D. Tex. 1962); Palmer v. Mathis, 62-2 CCH U.S. Tax Cas. ¶ 9636 (D. Ark. 1962); Rice v. United States, 197 F. Supp. 223 (E.D. Wis. 1961); Wilner v. United States, 195 F. Supp. 786 (S.D.N.Y. 1961). *Contra*, Landry v. United States, 227 F. Supp. 631, (E.D. La. 1964); McCarthy v. United States, 232 F. Supp. 605 (D. Mass. 1964); Ossip v. United States, 63-2 CCH U.S. Tax Cas. ¶ 9835 (W.D. Pa. 1963); Browne v. United States, 63-2 CCH U.S. Tax Cas. ¶ 9696 (D. Mass. 1963); Bacon v. United

courts passed on the quesction, a majority of them now finding for the Government.[73] However, since the question is one of fact, much deference will be given to the lower court decision, as required by recent Supreme Court decisions on gift versus compensation.[74] The question is complicated by differences of view among the appellate courts as to the proper scope of review, and the fact-law paradox. Some appellate courts feel that if the evidentiary facts—documents, *et cetera*—are not in dispute, an appellate court is in as good a position as the trial court to draw an intelligent inference as to the legal characterization of the transaction—gift or compensation.[75]

States, 64-1 CCH U.S. Tax Cas. ¶ 9163 (E.D. Ky. 1963); Carson v. United States, 317 F.2d 370 (Ct. Cl. 1963).

72. Katherine Shaw Dickson, 23 CCH Tax Ct. Mem. 1161 (1964); Ida Maltzman, 23 CCH Tax Ct. Mem. 829 (1964); Estate of Doumakes, 22 CCH Tax Ct. Mem. 1247 (1963); Irene M. Waters, 22 CCH Tax Ct. Mem. 1258 (1963); Estate of Louis Rosen, 21 CCH Tax Ct. Mem. 316 (1962); Margaret H. D. Penick, 37 T.C. 999 (1962), *appeal dismissed per stipulation*, CCH 1965 STAND. FED. TAX REP. ¶ 644.4741 (3d Cir. 1964); Estate of Cooper, 20 CCH Tax Ct. Mem. 774 (1961). Compare Estate of William Enyart, 24 CCH Tax Ct. Mem. 1447 (1965), in which $10,000 paid to the widow of a former employee was held excludable as a gift under § 102. The $5,000 death benefit exclusion of § 101(b) was applied against other post-death compensation payments received.

73. Courts of Appeal finding such payments to be gifts, as listed by circnits, are: Greentree v. United States, 338 F.2d 946 (4th Cir. 1964); Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962); United States v. Pixton, 326 F.2d 626 (5th Cir. 1964), 32 U. CINC. L. REV. 108 (1963); Estate of Martin Kuntz, Sr. v. Commissioner, 300 F.2d 849 (6th Cir.), *cert denied*, 371 U.S. 903 (1962); United States v. Frankel, 302 F.2d 666 (8th Cir.), *cert. denied*, 371 U.S. 903 (1962); Estate of Olsen v. Commissioner, 302 F.2d 671 (8th Cir.), *cert. denied*, 371 U.S. 903 (1962); United States v. Kassynski, 284 F.2d 143 (10th Cir. 1960).

Courts of Appeal, listed by circuits, finding such payments to be taxable are: Wright v. Commissioner, 336 F.2d 121 (2d Cir. 1964); Findlay v. Commissioner, 332 F.2d 620 (2d Cir. 1964); Gaugler v. United States, 312 F.2d 681 (2d Cir. 1963); Smith v. Commissioner, 305 F.2d 778 (3d Cir.), *cert. denied*, 371 U.S. 904 (1962); Martin v. Commissioner, 305 F.2d 290 (3d Cir.), *cert. denied*, 371 U.S. 904 (1962); Froehlinger v. United States, 331 F.2d 849 (4th Cir. 1964); Tomlinson v. Hine, 329 F.2d 462 (5th Cir. 1964); Evans v. Commissioner, 330 F.2d 518 (6th Cir. 1964); Fritzel v. United States, 339 F.2d 995 (7th Cir. 1964); Cronheim's Estate v. Commissioner, 323 F.2d 706 (8th Cir. 1963). Note the splits in 4th, 5th, 6th, and 8th circuits. These splits may be more apparent than real, however, because of factual distinctions.

74. Commissioner v. Duberstein, 363 U.S. 278 (1960). Note the comment by Dean Criswold, *supra* note 65, to the effect that lower courts and the bar need more direct guidance in this area than furnished by the Court. There seems at first glance to be some inconsistency between the subjective test of *Duberstein* and the more objective approach exemplified in Commissioner v. LoBue, *supra* note 52. However, in *LoBue* the question concerned only the interpretation of the general definition of gross income in the predecessor of § 61, there being no basis for the contention that the bargain purchase was a gift. In *Duberstein*, the issue was the tension between § 61 and § 102, the latter more clearly calling for a subjective inquiry into the motive for the benefit conferred.

75. Bounds v. United States, *supra* note 70. More recently, following the *Duberstein* decision, that court (the Fourth Circuit, similarly speaking through Chief Judge Sobeloff), regards the *Bounds* case as utilizing "a now unacceptable standard for

Others feel that the proper division of labor between the trial court and the appellate court requires deference to the trial court's conclusion on questions of ultimate fact, such as whether the employer intended to make a gift.[76]

The final turn of the screw seems to have been performed in 1962 when Congress adopted the twenty-five dollar limit on "business gifts."[77] This provision will apparently apply to bring this result. If the employer claims deduction for amounts in excess of the 5,000 dollar exclusion plus twenty-five dollars paid to beneficiaries of deceased former employees, the amount must be considered compensation, tax must be withheld, and the amount reported as wages. The amount which is excludable as a death benefit under section 101(b) is not considered a gift for this purpose. The recipient will be permitted to exclude 5,000 dollars but the balance will be taxable unless the taxpayer is able to establish, probably by litigation if at all, that the payment was a gift. This litigation could indirectly jeopardize the payor's deduction. On the other hand, if the payor wishes to support the position of the recipient, he must sacrifice deduction on his part. It seems likely that most employers will choose to deduct the amounts, tending to commit the recipient to taxability on amounts over 5,000 dollars. It is conceivable that a controlled close corporation might see fit to sacrifice its deduction at the corporate rates in favor of exclusion by a high-bracket shareholder-recipient. The success of this seems unlikely, since the shareholder status furnishes an additional argument against gift characterization, although not all shareholder-recipients have been taxed.[78] But it is arguable that the interests of the corporation have been impaired for the benefit of a particular shareholder, and creditors or minority shareholders might be able to attack the transaction successfully.[79] Since counsel for the close-held corporation is likely

review." Poyner v. Commissioner, *supra* note 73, at 290 n.5. Contrast the approach of the Sixth Circuit in Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962). The court recognized that the "clearly erroneous" rule applies to inferences from undisputed facts, but still found that a gift intent was the only reasonable inference from the factual pattern there presented.

76. Poyner v. Commissioner, *supra* note 73.

77. Int. Rev. Code of 1954, § 274(b), added by 76 Stat. 960 (1962). See 16 ABA, Section of Taxation Bull. No. 2, Point to Remember No. 6 (Jan. 1963).

78. Compare Schner-Block Co. v. Commissioner, 329 F.2d 875 (2d Cir. 1964), *with* Pizitz, Inc. v. Patterson, 64-2 CCH U.S. Tax Cas. ¶ 9526 (N.D. Ala. 1964). See also Yohlin, *supra* note 65, at 216.

79. Compare Spirt v. Bechtel, 129 F. Supp. 872 (S.D.N.Y. 1955), *aff'd in part and rev'd in part*, 232 F.2d 241 (2d Cir. 1956), raising a similar argument against corporate waiver of deduction under a restricted stock option plan pursuant to § 421(a)(2) before the 1964 amendments. Counsel's opinion that the claim for deduction was worthless—the option being non-compensatory—served to protect the directors and officers. The decision in Commissioner v. LoBue, *supra* note 52, casts serious doubts on counsel's opinion.

to be the same as counsel for the leading shareholders, what position should he take on this matter? Does his duty of loyalty to the corporate client dictate that he advise the corporation to claim the deduction, even though it may preclude the individual recipient from claiming exemption?

In addition to claiming that the payments in excess of 5,000 dollars are taxable to the recipient as compensation, the Service has pursued another and apparently inconsistent attack on the corporate deduction. Particularly where the recipient is also a shareholder, it has been sometimes successfully maintained that the payment was an informal dividend, and hence nondeductible. Apparently, the Service is experiencing increasing success in this line of attack, which is germane even to post-1962 cases.[80]

For a period, the Service took the position that the 1954 legislation showed that Congress intended to limit exclusion to 5,000 dollars.[81] The argument was not very persuasive when one considers that an entirely independent Code section excludes gifts from income, and this is the one on which taxpayers relied. The mere fact that the exclusion in the life insurance section is limited to 5,000 dollars is not determinative or even relevant, logically, to an asserted limit applying to the gift exclusion. Rebuffed by several court decisions, the Service finally abandoned this position, evidencing nonetheless an intention to continue to attack the gift characterization on its own merits.[82]

In summation, death benefits not exceeding 5,000 dollars will continue to receive favorable treatment, both to the payor and the recipient. Payments in excess of that will have to be characterized as compensation in order to preserve the corporate deduction. The taxpayer's chances of being able to receive gift treatment on amounts over 5,000 dollars, fading under previous law, are further reduced by the twenty-five dollar limit on business gifts and the accompanying reporting requirements and commitments.

9. *Employee Stock Options.*—Suppose that in Year 1, a corporate employer grants to a selected employee an option to purchase 100 shares of its stock at 100 dollars per share (fair market value) at

80. Interstate Drop Forge Co., 22 CCH Tax Ct. Mem. 701 (1963), *aff'd*, 362 F.2d 743 (7th Cir. 1964); Nickerson Lumber Co. v. United States, 214 F. Supp. 87 (D. Mass. 1963); Barbourville Brick Co., 37 T.C. 7 (1961); Harry L. Davis Co., 20 CCH Tax Ct. Mem. 1043 (1961). *But see* Rubber Associates, Inc. v. Commissioner, 335 F.2d 75 (6th Cir. 1964). See also cases cited note 78 *supra*.

81. Rev. Rul. 58-613 1958-2 Cum. Bull. 914; Note 9 J. Taxation 246 (1958). The decision was to follow the result reached in Bounds v. United States, *supra* note 70 (favorable to the taxpayer), for cases arising before the 1954 Code. The position of the Treasury was reserved as to post-1954 cases.

82. Rev. Rul. 62-102, 1962-2 Cum. Bull. 37.

any time over the following three years. In Year 3, when the fair market value of the stock has climbed to 200 dollars, the employee exercises the option, purchasing 100 shares at 100 dollars each, or 10,000 dollars. By hypothesis, the value of the stock so purchased is 20,000 dollars. Suppose further that in Year 7, when the fair market value of the stock is 300 dollars per share, the employee sells the shares on the open market, receiving 30,000 dollars. What tax consequences flow from these transactions? For many years, the Service urged that the employee realized ordinary compensation income in the amount of 10,000 dollars in the year the stock was purchased from the employer. Since the amount included in ordinary income with respect to the acquisition of property is added to its cost-basis,[83] the employee would realize 10,000 dollars long term capital gain (30,000 dollars less 20,000 dollars cost-basis) in the year of sale. But the lower courts continued to recognize the distinction between compensatory and proprietary options—the latter being motivated by the desire to encourage stock ownership, thereby ensuring the employee's loyalty and effort. Proprietary characterization was made more likely if there was little or no "initial spread"—difference between the option price and fair market value at the time the option was granted.[84]

After its victory in *Commissioner v. Smith* in 1945,[85] the Treasury Department amended the regulations to provide (prospectively) that any bargain purchase by an employee from an employer resulted in ordinary income as a form of compensation.[86] The Senate Finance Committee Report in 1950 stated the Committee's belief that "these Regulations go beyond the decision of the Supreme Court in *Commissioner v. Smith*. . . ."[87] Nevertheless, in 1956 that Court upheld taxability of options despite recitals tending to support proprietary characterization. It appeared in *Commissioner v. LoBue*[88] that the Court was willing to infer compensatory intent from the employment relationship, establishing a more objective test. The present regulations have, since 1961, confirmed this view.[89]

Meanwhile, Congress was developing a legislative solution to the problem which was based upon the premise that encouragement of stock ownership by employees was a wise policy, tending to thwart

83. McCullough v. Commissioner, 153 F.2d 345 (2d Cir. 1946).
84. Delbert B. Geeseman, 38 B.T.A. 258 (1938). See generally Lyon, *Employee Stock Options under the Revenue Act of 1950*, 51 Colum. L. Rev. 1 (1951).
85. 324 U.S. 177, *rehearing denied* 324 U.S. 695 (1945).
86. Treas. Reg. 111 § 29.22(a)-1 (1945), as amended, T.D. 5507, 1946-1 Cum. Bull. 18.
87. S. Rep. No. 2375, 81st Cong., 2d Sess. 59-60 (1950).
88. *Supra* note 52.
89. Treas. Reg. § 1.421-6 (1963).

the undesirable effects of separation of ownership from management. The tax law adopted in 1950 implemented this policy in the following manner.[90] If certain requirements related to "restricted stock options" were met, then the mere grant of the option was to have no immediate tax effect, a form of nontaxable compensation. Neither was the exercise a taxable event, the "compensation" still being nontaxable. Only when the shares were sold was a tax imposed, and that tax would be at the lower capital gain rate. In the example given, the employee would be taxed on 20,000 dollars of long term capital gain (30,000 dollars less 10,000 dollars cost-basis) with a maximum tax of 5,000 dollars[91] imposed in the year of sale. If the employee decided not to sell the shares, but to hold them and let them pass through his estate at death, their basis would be "stepped-up" to an amount equal to their then fair market value, perhaps 30,000 dollars.[92] They could be sold by the executor or heir without imposition of any tax whatever. The effect in this case is truly nontaxable compensation.

The requirement that the option not be transferable except by will or intestacy gave "restricted stock options" their name. Initial spread was limited to fifteen per cent (i.e., the option price had to be at least eighty-five per cent of the value at the time the option was granted), and if initial spread exceeded five per cent, all initial spread was treated as compensation income in the year in which the shares were disposed of, or if held until death, in that year. Shares were required to be held for more than six months after the exercise of the option, and could not be disposed of until more than two years from the date the option was granted, or the favored treatment was forfeited. Finally, the employee could not own, at the time the option was granted more than ten per cent of the stock of the corporation, measured by voting power. If initial spread exceeded fifteen per cent, the beneficial treatment was entirely withdrawn, and the controlling case law required inclusion of the spread at the time of exercise as ordinary income. This meant that close corporations whose stock was not actively traded could not employ the restricted stock option to attract high calibre executive talent, since the value of the stock was not accurately ascertainable. The prohibition on the employee's owning more than ten per cent of the voting power clearly precluded use of restricted stock options for the major shareholder-employees of close corporations.

President Kennedy, in his Tax Message of 1963, recommended repeal of the favorable treatment given to restricted stock options,

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90. Int. Rev. Code of 1939, § 130A, added by ch. 994, 64 Stat. 906 (1950) (now INT. REV. CODE OF 1954, as amended 78 Stat. 19 (1964)).

91. INT. REV. CODE OF 1954, § 1201(b).

92. INT. REV. CODE OF 1954, § 1014.

which he regarded as clearly compensation that should be taxed at ordinary rates.[93] The opposition of industry leaders, typified by Henry Ford, II who testified to the utility of stock options in attracting and retaining top management personnel (he himself being disqualified from securing such benefits), persuaded Congress that such drastic action as that recommended by the President was not required.[94] Remedial change in the existing provisions could eliminate the areas of abuse without withdrawing from industry this valuable competitive aid. Two major changes were introduced.[95] The former allowance of up to fifteen per cent initial spread was removed from the law. Only if there is zero initial spread may the option qualify as what is now known as a "qualified stock option." Secondly, the required holding period was extended from six months to three years from the date the option is exercised, without reference to the time the option was granted.

Realizing that the strict requirement of zero initial spread might prove difficult to meet precisely, in view of the degree of uncertainty which surrounds stock values in some cases, this provision was softened in its impact. Whereas before 1964, failure to meet the minimum option price requirement led to complete forfeiture of the benign treatment, under the new law some lee-way is permitted, though at a heavy price. If the option price falls short of the fair market value, 150 per cent of this amount is treated as ordinary income at the time the option is exercised.[96] To illustrate, if in the foregoing example the option price had been ninety dollars, then the employee would have fifteen dollars per share of ordinary income in the year he purchased the stock, which would be added to the basis of his shares. The basis being 105 dollars their sale for 300 dollars per share would yield 105 dollars long term capital gain.

The significance of this lee-way provision (which depends upon a good faith effort at accurate evaluation) for close corporations is considerable. Subject to the risk of some amount of ordinary income treatment, qualified employee stock options would seem now to be available to close corporations for use in attracting qualified executive personnel not presently stockholders in the corporation. The prohibition against an employee owning more than ten per cent of the stock has been made even more severe, precluding

93. *Op. cit. supra* note 48, at 25.
94. *Id.* pt. 2, at 1127-46.
95. The 1964 amendments led to re-numbering of the § 421 group as follows: Section 421 of the prior law was re-numbered 424, and retained for options granted before January 1, 1964. The new rules for "qualified stock options" are contained in §§ 421, 422, & 425, Section 422 being the main provision. "Employee Stock Purchase Plans" are dealt with in § 423.
96. Int. Rev. Code of 1954, § 422(c)(1).

use of the options for existing shareholder-employees, unless their holdings do not exceed five per cent. As often in recent years, Congress kept a friendly eye on small business and softened the rigor of the five per cent rule for corporations whose equity capital is less than 2 million dollars. Corporations with equity capital not exceeding one million dollars are permitted to extend qualified stock options to employees owning not more than ten per cent, the old rule being retained for this class of small business corporations. If equity capital exceeds one million dollars, the percentage is reduced proportionately.[97]

In addition to qualified stock options, designed for selected executive personnel, the 1964 amendments extend favored treatment to "employee stock purchase plans," under which options are granted on a wide scale to the non-executive employees, all of whom own less than five per cent of the stock, measured by voting power or value. For these plans, the former requirement that the option price be not less than eighty-five per cent of the fair market value at the time the option is granted, is retained.[98] Close-held corporations will do well to canvass the possibility of making use of these formerly unavailable benefits for their employees.

B. *Deferred Compensation*

Deferred compensation in a broad sense includes any arrangement whereby the taxability of earned income is postponed to a year later than the one in which the services were rendered. The term includes contractual arrangements deferring the receipt of all or a portion of compensation—deferred compensation in the narrow sense—as well as "qualified" pension and profit-sharing plans which are extended much favor under present tax law.[99] These I term the major of the minor tax benefits of incorporation.

While the minor tax advantages denominated nontaxable compensation are significant, the major of the minors—deferred compensation—is so attractive that it might tip the scales in favor of incorporation. This would be true, for example, in the case of a medical clinic which could organize in such form as to qualify as a corporation, making available to the professional men involved the benefits usually reserved for employees of business corporations.[100] But in the total perspective, these are still minor tax considerations.

97. INT. REV. CODE OF 1954, § 422(b)(7).

98. INT. REV. CODE OF 1954, § 423.

99. INT. REV. CODE OF 1954, § 401. For general discussions, see Rice, *The New Tax Policy on Deferred Compensation*, 59 MICH. L. REV. 381 (1961); Strecker, *Taxation of Retirement Provision*, 27 LAW & CONTEMP. PROB. 67 (1962).

100. See notes 17 & 18 *supra*.

V. Major Tax Analysis

The major tax analysis depends upon the comparative rates of tax applicable to individuals and corporations. Put most simply, it would appear that the corporate form would be advantageous in any case where the corporate rate would be lower than the rate applicable to individuals if the enterprise were conducted as a proprietorship or partnership. Under the rate structure applicable to taxable years after 1964 the maximum corporate rate is forty-eight per cent.[101] When individual taxable income exceeds 22,000 dollars the marginal rate becomes fifty per cent, and climbs steadily to a maximum of seventy per cent on income over 100,000 dollars.[102] Could it be said that where the individual taxable income of the owners exceeds 22,000 dollars (44,000 dollars in the case of married persons filing joint returns), the corporate form will be advantageous, but otherwise not?[103] The question is complicated by the fact that corporate income below 25,000 dollars is taxed at only twenty-two per cent, while individual taxable incomes over 6,000 dollars are taxed at twenty-five per cent or more. Most importantly, the simple rules of thumb suggested by the above two comparisons can be seriously misleading because of the so-called double taxation of corporate business income.[104] That is, corporate business income is subject to tax at twenty-two through forty-eight per cent, and in the normal course of events the net income after tax distributed to the shareholders as dividends is further taxed at fourteen through seventy per cent.[105] The simple rate comparison

101. Int. Rev. Code of 1954, § 11.

102. Int. Rev. Code of 1954, § 1(a)(2).

103. See generally Shockney, & Sweeney, Tax Effects of Operating as a Corporation or Partnership (1957); Willis, Partnership Taxation 470-80 (1957); Boughner, *Tax Advantages in Incorporating the Small Business*, 44 Ill. B.J. 300 (1956); Caplin, *Income Tax Pressures on the Form of Business Organization: Is It Time for a "Doing Business" Tax?* 47 Va. L. Rev. 249 (1961); Clapp, *When is it Desirable Taxwise to Incorporate a Partnership?* N.Y.U. 10th Inst. on Fed. Tax 1107 (1952); Fillman, *New Considerations in Selecting the Type of Business Organization*, 1956 Tul. Tax Inst. 676; Friedman & Silbert, *Form of the Entity and its Capital Structure in Real Estate Acquisitions*, N.Y.U. 16th Inst. on Fed. Tax 609 (1958); Garcia, *When Should a Sole Proprietor Incorporate His Business to Save Income Taxes?* 35 Taxes 110 (1957); Korner, *Tax Factors in Doing Business as a Corporation*, 10 S.C.L.Q. 607 (1958); Ray & Hammonds, *Corporation or Partnership: Tax Considerations*, 36 Taxes 9 (1958); Tritt & Spencer, *Current Tax Problems in Incorporation of a Going Business*, U. So. Cal. 1958 Tax Inst. 71; Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey* 10 W. Res. L. Rev. 9, 10-15 (1959); Note 30 B.U.L. Rev. 248 (1950).

104. For general discussions of the problem which has been more blandly termed "relative over-taxation of corporate earnings," see Goode, The Corporation Income Tax (1951); Holland, Dividends Under the Income Tax (1962); 40 Taxes 543 (1962), reviewed in Holland, The Income Tax Burden on Stockholders (1958); Soule, *Simplified Formula for "Partnership" Taxation of Corporate Income*, 37 Taxes 701 (1959); U.S. Treas. Dep't, President's Tax Message, 167-76 (1961); Tax Policy League, How Shall Business Be Taxed? (1937).

105. Int. Rev. Code of 1954, §§ 301, 316-17.

overlooks the fact that the corporate tax is not in lieu of, but is in addition to the ultimate shareholder tax. The major efforts of corporate tax counsel are oriented toward reduction or elimination of the dual tax impact. Two principal avenues of approach are open. One is directed toward elimination or reduction of tax at the corporate level. The payment of reasonable salaries for services rendered by shareholder-employees, reasonable rental for shareholder-owned property leased to the corporation, or interest on indebtedness owed to shareholders accomplish this goal because the payments (unlike dividends) may be deductible, eliminating the item at the corporate level.[106] Note that this is accomplished by the substitution of a current shareholder tax, which might be at a higher level than the applicable corporate rate. To the extent that such devices are successful, they accomplish pro tanto the same major tax result as a proprietorship or partnership.

The other major route to elimination of the double tax is directed at reduction or elimination of the ultimate shareholder tax. The model case, though not very realistic, would be one where the corporation never pays dividends, and the shares are sold or the corporation liquidated after the original shareholders have died. The shares have received a basis stepped-up to fair market value at death,[107] and the gain computed on sale or liquidation by the executor or heir is zero.[108] While Congress has imposed rather effective limitations on the degree to which earnings may be allowed to accumulate, there is an area for effective planning.[109] And even where the original shareholders sell their shares,[110] or liquidate the corporation partially or completely,[111] or redeem their shares (under severely limited conditions),[112] the amount received may be given capital gain treatment. Capital gain treatment connotes not only the favorable rate (never more than twenty-five per cent, often less) but also the permissible offset of the cost-basis of the shares against the amount received before any taxable gain is computed.[113] To the degree that

106. INT. REV. CODE OF 1954, §§ 162-63.
107. INT. REV. CODE OF 1954, § 1014.
108. INT. REV. CODE OF 1954, § 1001.
109. INT. REV. CODE OF 1954, §§ 531-37, impose a penalty tax of 27½% to 38½% on earnings (after ordinary corporate tax) accumulated by a corporation which is formed or availed of for the purpose of avoiding surtax on its shareholders. Generally, accumulations beyond the reasonable needs of the business are within its purview. INT. REV. CODE OF 1954, §§ 541-47, impose an even more severe penalty tax of 70% on the undistributed earnings (after ordinary corporate tax) of personal holding companies.
110. INT. REV. CODE OF 1954, §§ 1001, 1201-02.
111. INT. REV. CODE OF 1954, §§ 331, 346.
112. INT. REV. CODE OF 1954, §§ 302-04, 318.
113. INT. REV. CODE OF 1954, § 1001. When a stock redemption is treated as a dividend, the entire proceeds (up to the amount of earnings and profits) are taxable

earnings can be accumulated without encountering the penalty tax and realized as capital gain in a sale, liquidation, or redemption, the ultimate shareholder tax may be materially reduced.

Finally, the use of the money representing the temporary or immediate saving that results from substitution of the lower corporate tax rate may generate enough income to more than offset any remaining disadvantage arising from a controlled and reduced ultimate shareholder tax. The variables involved, and the perspective required for competent planning in the choice of business form can be illustrated by a series of hypothetical cases not atypical of what will be encountered in practice. The cases illustrate the interaction of the two main variables, level of corporate income and level of individual income, complicated by immediate versus overall tax burdens, and the possibility of capital gain treatment for the ultimate shareholder tax.

A. *Hypothetical Cases*

Case I: *Low Corporate and Low Shareholder Income.*— *A* and *B* contemplate formation of Alpha Corporation to carry on a business to be owned one-half by each. Neither has income from other sources and both intend to devote full time to the new venture. The expected net income before taxes is 8,000 dollars per year, after payment of a salary of 4,000 dollars to each. *A* and *B* are both single individuals, neither of whom qualifies as head of a household.

1. *A B Partnership*

Individuals' Tax			
Gross Income:			
Salary	$4,000		
Distrib. Share	4,000		
10% Opt. Std. Ded.	–800		
Pers. Exemp.	–600		
Taxable Income	6,600		
	–6,000	Tax on 6,000:	1,130
	600	Tax at .25	150
			1,280
			x 2
Total Tax Burden:			$2,560

without offsetting basis. See Katcher, *The Case of the Forgotten Basis,* 48 MICH. L. REV. 465 (1950); Treas. Reg. § 1.302-2(c) (1955).

2. *Alpha Corporation*

Corp. Tax, Inc.	$8,000		
Tax at .22	–1,760		
Net Inc. after tax	6,240		

(a) Assuming No Dividends

Individuals' Tax

Salary	$4,000		
10% Opt. Std. Ded.	–400		
Pers. Exemp.	–600		
Taxable Income	3,000		
	–2,000	Tax on 2,000	$310
	1,000	Tax at .19	190
			$500
			x 2
Total Individuals' Tax:			$1,000

Comparative Tax Burden:

Corp. Tax	1,760	
Indiv. Tax	1,000	
Total	2,760	
Partnership	–2,560	
Immediate Detriment	[200]	per year

(b) Assuming Dividend Tax

Individuals' Tax

Salary	$4,000		
Divds. 3,120 Less –100 Excl.	3,020		
Gross Income	7,020		
10% Opt. Std. Ded.	–702		
Pers. Exemp.	–600		
Taxable Income	5,718		
	4,000	Tax on 4,000:	$690.00
	1,718	Tax at .22	377.96
			1,067.96
			x 2
Total Individuals' Tax:			$2,135.92

Comparative Tax Burden:

Corp. Tax	$1,760.00
Indiv. Tax	2,135.92
Total	3,895.92
Partnership	2,560.00
Overall Tax Detriment	[1,335.92] per year

(c) Assuming Capital Gain Tax

Individuals' Tax:

Salary	$4,000		
Cap Gains 3120/2	1,560		
Gross Income	5,560		
10% Opt. Std. Ded.	–556		
Pers. Exemp.	–600		
Taxable Income	4,404		
	–4,000	Tax on 4,000:	$690.00
	404	Tax at .22	88.88
			778.88
			x 2
Total Individuals' Tax:			$1,557.76

Comparative Tax Burden:

Corp. Tax	$1,760.00
Indiv. Tax	1,557.76
Total	3,317.76
Partnership	–2,560.00
Overall Tax Detriment	[757.76] per year
Overall Tax Detriment assuming divd. tax	[1,335.92]
Reduction in overall Tax Detriment	[578.16]

A similar computation, not reproduced here, was performed with respect to each of the other three hypothetical cases. The results are summarized and compared in the table, "Analysis of the Major Tax Advantage or Detriment Resulting from the Use of the Corporate versus the Partnership Form."

Case II: *Low Corporate and High Shareholder Income.*—*C* and *D* contemplate formation of Beta Corp. to carry on a business to be owned one-half by each. Neither has income from other sources and both intend to devote full time to the venture. The expected net income before taxes is 25,000 dollars per year, after payment of a salary of 15,000 dollars to each. *C* and *D* are both single individuals, neither of whom qualifies as head of a household.

Case III: *High Corporate and Low Shareholder Income.*—*S1* through *S10* contemplate formation of Gamma Corporation to carry on a business to be owned one-tenth by each. All shareholders except *S1* and *S2* have outside income of 4,000 dollars. Only *S1* and *S2* will be employed by the corporation, as President and Vice President respectively. The expected net income before taxes is 100,000 dollars per year, after the payment of salaries of 4,000 dollars each to *S1* and *S2*. *S1* through *S10* are single individuals, none of whom qualifies as head of a household.

Case IV: *High Corporate and High Shareholder Income.*—*X* and *Y* contemplate formation of Delta Corporation to carry on a business to be owned one-half by each. Neither has income from other sources and both intend to devote full time to the new venture. The expected net income before taxes is 100,000 dollars per year, after payment of a salary of 22,000 dollars to each. *X* and *Y* are both single individuals neither of whom qualifies as head of household.

B. *Conclusions Regarding the Hypothetical Cases*

Case I illustrates that where both business and individual income are low, the corporate form is disadvantageous from both the immediate and overall tax viewpoints, under the eye of the major tax analysis. This conclusion holds even if it is assumed that all corporate earnings are retained for eventual realization as capital gains. It may be surprising that the corporate form results in detriment even from the immediate point of view. The reason is that while the corporate rate on small corporations is only twenty-two per cent, it is a flat rate, applying from the first dollar of corporate income. The graduated individual tax, on the other hand, starts at fourteen per cent and much of the income of these men would be taxed at less than twenty-two per cent if received as partnership income. Since the corporate form is disadvantageous tax-wise from both the immediate and overall points of view, even assuming capital gain treatment, partnership seems to be the indicated choice. Would the minor tax benefits still make the corporate form attractive? Also, can these men afford to take the risk of personal liability involved in the

Analysis of the Major Tax Advantage or Detriment Resulting From the Use of the Corporate Versus the Partnership Form

		Partnership Tax	Corporate Tax	Individual Tax (No Divds)	Immediate Advantage [Detriment]	Individual Tax (Dividends)	Overall [Detriment]	Individual Tax (Capital Gain)	Overall Advantage [Detriment]
		A	B	C_1	$B+C_1-A$	C_2	$B+C_2-A$	C_3	$B+C_3-A$
Case I		2,560	1,760	1,000	[200]	2,135.92	[1,335.92]	1,557.76	[757.76]
Low Corp	8,000								
Low Sh 'h	4,000								
Case II		16,210	5,500	6,308	4,403	13,661.60	[2,951.60]	9,741.50	968.50
Low Corp	25,000								
High Sh 'h	15,000								
Case III		28,300	41,500	5,000	[18,200]	16,700.00	[29,900]	10,491.50	[23,691.50]
High Corp	100,000								
Low Sh 'h	4,000								
Case IV		62,956	41,500	11,420	10,036	39,702.00	[18,246]	26,045.00	[4,589]
High Corp	100,000								
High Sh 'h	22,000								

partnership form? These questions are considered later in connection with the subchapter S election.

Case II shows that where shareholder income is high, and corporate income is low, immediate tax advantage of significant amount will arise. Whether the overall tax detriment will outweigh this depends on the comparative amounts and on the certainty of the ultimate shareholder tax. Where profits are accumulated and later realized as capital gains, the overall tax detriment may disappear, as it did here. When minor tax benefits are thrown in the balance, corporate form would appear very attractive in this situation.

Case III indicates that where shareholder income is low (as where there are many shareholders), even though corporate income is high, corporate form may prove disadvantageous from both the immediate and overall view, despite the possibility of capital gain treatment. Somewhat surprisingly, long-term subchapter S election might be attractive to some comparatively large corporations.

Case IV, when compared with Case II, shows that where shareholder income is high, immediate tax advantage results whether corporate income is high or low. Thus, the level of individual income is the more important factor.

As we review the considerations discussed, the following picture emerges. Where individual income is high, and even more clearly where business income also is high, the corporate form will be attractive for its immediate tax savings and the minor tax benefits of nontaxable and deferred compensation. While corporate form always involves a tax detriment if it is assumed that all earnings will be paid out as dividends, the possibility that some earnings will be transformed into capital gain may reduce or eliminate the overall disadvantage. Finally, the operation of the corporate form as a massive tax-deferral mechanism, making available large amounts of funds for long periods of time, may more than offset the theoretical detriment. The private law advantages of limited liability, free transferability of interests, centralized management, and continuity of life may be achieved consistent with the most desirable tax treatment.

VI. Subchapter S Election: The Best of All Possible Worlds?

But there is a large class of small business investor-entrepreneuers whose personal and business income are both relatively low, and whose tax situation indicates the choice of the partnership. Corporate form, in addition to the overall detriment which always appears, even imposes an immediate detrimental tax burden. Yet, private law considerations, chiefly limited liability, may compel choice of the corporate form. Recognizing that a hardship is involved in such cases, Congress, in 1958, enacted subchapter S of the Internal Revenue Code, for the avowed purpose of removing the tax consideration from the choice of business form.[114] While the legislation falls far short of that stated objective, increasingly widespread adoption of its elective treatment indicates that a need is being met.[115]

The general objective lying somewhat remotely behind subchapter S and appearing only furtively in its substantive provisions, seems to have been to extend partnership-like tax treatment to an electing "small business corporation." Of course, the different legal nature of a corporation, however small, may impose certain implicit limits on the accomplishments of this objective. Three essential features of partnership tax treatment have been extended under Subchapter S. First,

114. INT. REV. CODE OF 1954, §§ 1371-77. "Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence." S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958). The author's survey of the literature leads him to estimate that the articles, notes, and books on subchapter S published since 1958 may exceed 100. Some of the best are as follows: Anthoine, *Corporate Tax Election to Pass Income and Loss to Shareholders*, 1958 PRACTICING LAW INST.; Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1146 (1958); Borsook, *Few Personal Holding Companies Will Qualify for Subchapter S Election*, 10 J. TAXATION 19 (1958); Caplin, *Partnership or S Corporation?: A Check List of the Tax factors in the Choice*, 12 J. TAXATION 32 (1960); Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 VA. L. REV. 61 (1960); Cowen, *Many Potential Problems are Inherent in Subchapter S Election*, 17 J. TAXATION 86 (1962); Greene, *Practitioners' Experiences with Subchapter S Reveal Many Doubts, Fears; Use is Limited*, 10 J. TAXATION 130 (1959) (text less pessimistic than title); Kalupa, *Remedy of Defects in Subchapter S Asked by ABA Taxation Committee*, 11 J. TAXATION 196 (1959); Kalupa, *Subchapter S Election May Cause Increase in State Taxes*, 10 J. TAXATION 137 (1959); Landis, *Advantages and Disadvantages of the Subchapter S Election*, N.Y.U. 18TH INST. ON FED. TAX 723 (1960); Meyer, *Subchapter S Corporations*, 36 TAXES 919 (1958); Meyer, *One Year of Subchapter S*, 38 TAXES 105 (1960); Lourie, *Subchapter S After Six Years of Operation: An Analysis of Its Advantages and Defects*, 22 J. TAXATION 166 (1965); Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453 (1959); Roemele, *Business Purpose and the Subchapter S Reorganization*, 58 MICH. L. REV. 531 (1960); Stein, *Optional Taxation of Closely Held Corporations under the Technical Amendments Act of 1958* 3 TAX COUN. Q. 63 (1959); Stine, *Subchapter S Election May Increase State Income Tax on Corporation or Stockholders*, 10 J. TAXATION 91 (1959); Teschner, *Advantages of Periodic Inspection to Close Tax Traps Facing Small Corporations*, 10 J. TAXATION 13 (1959); Willis, *Subchapter S: A Lure to Incorporate Proprietorships and Partnerships*, 6 U.C.L.A.L. REV. 505 (1959); Wright, *Utilization of Subchapter S and Section 1244 Stock*, 12 W. RES. L. REV. 225 (1961); Wright & Libin, *Impact of Recent Tax Stimulants on Modest Enterprises*, 57 MICH. L. REV. 1131 (1959); Note, 72 HARV. L. REV. 710 (1959); Note, 33 ST. JOHN'S L. REV. 187 (1958) (excellent).

115. Lourie, *supra* note 114, at 166, estimates that 10% of all corporations are now being taxed under subchapter S, or perhaps more accurately, not being taxed. Lourie proposes a number of improvements which would make subchapter S come closer to extending partnership-type treatment to electing corporations. Caplin, *supra* note 114, at 61, who was addressing himself to Congress, recommended repeal and adoption of a new and better integrated solution to the problem.

the corporate tax is eliminated, the taxable income of the corporation being taxed currently to the shareholders, in proportion to their holdings. Earnings actually distributed are taxed in the year distributed. Earnings not distributed are taxed in the shareholders' taxable year during which ends the taxable year of the corporation. If both the corporation and its shareholders are on the same taxable year, as in the simple case where both use the calendar year, the computation is simplified. The second partnership feature is the pass-through of corporate capital gains. Ordinarily, the intervention of the corporate entity serves to alter the tax character of items passing through it. Subchapter S makes an exception for corporate capital gains, which retain their special tax treatment at the shareholder level. Finally, corporate net operating losses are allowed to be deducted by the shareholders—as ordinary and not capital losses—almost as they arise. As the corporate taxable year ends, often coincidentally with that of the shareholders, the latter are entitled to deduct their proportionate share of the corporate net operating loss.

As will be inferred, the analogy between a partnership and subchapter S is far from complete, and from the viewpoint of some writers, even attenuated. The author feels that the differences are often given exaggerated importance in an effort to call attention to them, important as they certainly are. While a non-electing corporation is a very imperfect conduit, changing the tax character of items passing through it, a partnership is an almost perfect conduit under present law. Subchapter S lies somewhere in-between. More importantly, election under Subchapter S does not change the essential tax character of the entity; it still remains a corporation for all other purposes of the tax law except to the extent changed by Subchapter S itself. Thus, for example, transfers of property in formation of a subchapter S corporation must qualify for tax-free treatment under section 351 in subchapter C, "Corporate Distributions and Adjustments," not under the analogous but simpler provisions of section 721 in subchapter K, "Partners and Partnerships." Of greater significance is the fact that the liquidation of a subchapter S corporation is treated the same as that of any other, normally a taxable exchange giving rise to recognized gain or loss. Partnership liquidation, on the other hand, is generally nontaxable. Distributions made by a subchapter S corporation are also treated as corporate distributions under subchapter C, leading to the possibility that ordinary dividend treatment might celebrate the withdrawal of previously-taxed earnings—a problem discussed later.

The imperfection of the analogy between a partnership and a subchapter S corporation has led to the not very successful search for an adequate shorthand description of this new hybrid introduced into the already crowded garden of business forms. The cutest is "corpnership," and while its light tone may lead some to reject it, there may be something to be said for a newly-coined word to describe a totally new and unique thing. "Pseudo-corporation" and "quasi-corporation" have gained some currency, but the former clearly (and the latter to some extent) connote that the corporate entity is lacking or imperfect. This is not true, as for all purposes of private law, a subchapter S corporation is a valid and viable legal entity, fully vested with limited liability and the other characteristics discussed earlier. Some refer to "electing corporations" or "tax-option corporations" but these terms seem too vague to communicate meaning to one not familiar with the problem, and inexact to the sophisticated. Since it does not appear to describe anything, but only to signal some undisclosed meaning to the uninitiated, and communicates exact meaning to those who have taken the trouble to become informed, the author prefers (until something better comes along) the term *Subchapter S corporation.*

In at least three situations, subchapter S would seem to offer—as Voltaire's caricature of the philosopher Leibniz, Dr. Pangloss, would say—the best of all possible worlds.[116] In the model case of low individual and low business income, the private law advantages of the corporate form are combined with partnership-type tax treatment. For new enterprises, however large, which may expect to suffer losses in the early years, ideal loss planning can be combined for the first time with the private law protection of limited liability. Finally, any corporation—regardless of size—which expects to have a large, nonrecurring capital gain may eliminate the dual tax by electing under subchapter S, even if for only one year. While the "one-shot" election is penalized to the extent of withdrawing the availability of subchapter S benefits for five years, many large corporations having nonrecurring major capital gains would not be seriously deterred by this consideration.

A. *Requirements for Subchapter S Election*

Unlike the provisions of section 1244 (enacted in the same bill) which introduce size—in terms of equity capital—into the definition of a "small business corporation," subchapter S could logically apply to a multi-million dollar concern, so long as it had no more than ten

116. VOLTAIRE, CANDIDE, 2, 117-18. Pangloss sometimes said to Candide: "There is a concatenation of events in this best of all possible worlds; for if you had not been kicked out of a magnificent castle for love of Miss Cunegonde; if you had not been put into the Inquisition; if you had not walked over America: if you had not stabbed the Baron: if you had not lost all your sheep from the fine country of El Dorado: you would not be here eating preserved citrons and pistachio-nuts."

"All that is very well," answered Candide, "but let us cultivate our garden."

shareholders. The ten shareholders must be natural persons or the estates of decedent former shareholders, the ownership of stock by a corporation, partnership, or trust serving to disqualify the corporation for election. All shareholders must be citizens or residents of the United States, and the corporation must be a domestic corporation, and cannot be a member of an affiliated group such as are permitted to file consolidated returns. Since the prohibition on corporate shareholders would prevent an electing corporation from being a subsidiary of another, the effect of this reference to affiliated groups is to preclude the subchapter S corporation from being a parent corporation, *i.e.*, owning eighty per cent or more of the stock of another corporation.[117] The nature of the income may also disqualify a corporation from election. If more than twenty per cent of its gross receipts are from passive investment sources of the personal holding company type, or if more than eighty per cent of the corporation's gross receipts are derived from sources outside the United States, disqualification ensues. Finally, the corporation must have only one class of stock, although the use of debt in the capital structure is not forbidden. If all these requirements are met, and if all shareholders consent to the imposition of tax on their shares of undistributed corporate taxable income, the filing of Form 2553 by the corporation will complete the election.

B. *Problems under Subchapter S*

Election, unfortunately for taxpayers, must be made without the aid of hindsight. An election for a particular taxable year of the corporation must be made within the first month of that year, or during the preceding month. Election may be discontinued in two ways: termination or disqualification. Termination is voluntary, unanimous, and is effective only prospectively, that is, for future taxable years. The commitment to subchapter S, made before the year's profits can be known, may not be withdrawn thereafter. Disqualification, presumably involuntary and perhaps even inadvertent, has retroactive effect. Any circumstance which would cause the corporation no longer to meet the definitional requirements will serve to disqualify. Thus, if one share of stock is transferred in trust, if the corporation issues a new preferred stock, or if the income includes too much of the passive investment type, election is "terminated" as of the first of the year. Obviously some of these events might be brought about with the evident purpose of causing termination of the election. One cause for concern to those considering election under

117. INT. REV. CODE OF 1954, § 1371(d), added by 78 Stat. 19 (1964), permits an exception for a wholly inactive subsidiary which does no business and has no taxable income. The reason for this was to accommodate certain corporations which form inactive subsidiaries in certain states in order to protect the corporate name.

subchapter S is the fact that any shareholder has the power to bring about retroactive termination of the election unilaterally. The power might even be used vindictively. The legal effect of agreements among shareholders, precluding the steps which would cause disqualification, might be questioned since Congress clearly intended that all the shareholders must consent to election. One reason may have been that there is a question as to the constitutionality of a tax which would require inclusion in shareholders' returns of corporate profits before their division.[118] On the other hand, voluntary revocation requires unanimous action as does election, perhaps indicating that a shareholder's commitment is not lightly to be reversed. Indeed, this requirement of unanimity for voluntary termination of election argues strongly for the validity of reasonable protective agreements.

Another area of difficulty which has appeared is the uncertainty which clouds a transfer of stock to a new shareholder, whether by death or inter vivos. His consent is positively required rather than inferred from silence. During the period following such a transfer, the election is in jeopardy until a new consent is filed. For a period, there was a thirty-day deadline on this filing, but the Service has softened this requirement where the new shareholder ultimately manifests his consent.[119]

The most serious defect of subchapter S, which probably deters many from electing, may be called the "lock-in" of previously-taxed earnings. If a partner has paid tax on his distributive share left invested in the partnership, he may withdraw money tax-free up to this amount. The same is true of shareholders of subchapter S corporations, but with some important differences. The difficulty arises where a corporation which has a pre-election profit history (or has generated earnings and profits in excess of its taxable income) makes distributions in excess of its current taxable income, in a year when election is not in force. It could even apply to a distribution made at a time when election was in force, but was retroactively terminated through disqualification. Since all distributions are presumed to be made out of earnings and profits, it is conceivable that the subchapter S shareholder might be required to pay dividend tax on what he considered to be already-taxed earnings.[120] Of course, taxation is not entirely

118. Eisner v. Macomber, 252 U.S. 189 (1920). *But see* Eder v. Commissioner, 138 F.2d 27, 31 (2d Cir. 1943), which assumes the constitutionality of the provisions of the foreign personal holding company law (§§ 551-56) taxing undistributed income directly to the shareholders. Helvering v. National Grocery Co., 304 U.S. 282 (1938) (dictum), supports such treatment, at least in the case of the one-man corporation. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 180, 206 (1959). See also Dowdle, *Can Domestic Shareholders Be Taxed on Foreign Corporate Earnings Prior to Distribution?* 40 TAXES 436 (1962).

119. Lourie, *supra* note 114, at 170.

120. *Id.* at 168-69.

unjustified since the pattern of the corporate tax calls for it. However, in the context of subchapter S, it constitutes a serious failure to extend partnership-type treatment, and should be remedied. One solution is to reverse the presumption as to distributions made by former electing subchapter S corporations so that the previously-taxed earnings account is used before the distributions are deemed to represent earnings and profits. A related problem arises from the non-transferability of the previously-taxed earnings account. It is deemed personal to the owner (unlike the partnership situation), and does not become available to the new owner, not even as executor or heir.[121] Again, more nearly partnership-like treatment would seem appropriate. A guide to legislation in this area might be to treat the electing corporation's shareholders as much like partners for tax purposes as is administratively feasible and not inconsistent with the differences in the legal nature of the two "entities."

One recommended solution to the problem of the "freeze-in" of previously-taxed earnings would be to avoid the problem at the source. That is, make certain that all corporate taxable income is distributed, to be loaned back or re-invested in the form of additional stock, if corporate financial needs dictate. One difficulty is that the exact amount of the corporate taxable income cannot be known until after the end of the year, and then it is too late. One commentator recommended adoption of a rule which would treat distributions made during the early part of the following year as having been made on the last day of the preceding taxable year.[122] Analogies could be drawn from the field of trust taxation, deductions between related parties, personal holding companies, and the accumulated earnings tax. Adjusting distributions could then be completely effective to control this problem. Another difficulty, where the funds are re-invested, is the possibility that the Service would successfully ignore the transaction—treating the funds as previously-taxed undistributed earnings—or consider the debt instruments as a new and prohibited second class of stock.[123] Since complete and retroactive disqualification would result from the characterization of such debt as a second class of stock, the

121. *Ibid.*

122. *Ibid.*

123. The "thin incorporation" doctrine has recently been applied, as numerous commentators predicted that it would, to deny subchapter S status to a corporation whose indebtedness to shareholders was held to constitute a prohibited second (and preferred) class of stock. Henderson v. United States, 65-2 CCH U.S. Tax Cas. ¶ 9598 (M.D. Ala. 1965); Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964). The latter case was discussed in Angvire, *Thin Capitalization of Subchapter S Corporations,* 9 TAX COUNS. Q. 153 (1965). See generally Caplin, *The Caloric Count of a Thin Incorporation,* N.Y.U. 17TH INST. ON FED. TAX 771 (1959), for a comprehensive analysis of the cases, together with helpful suggestions and evaluation of the trend of the law in that area.

cure may be worse than the disease. It might be wiser to take the risk involved in having previously-taxed earnings remain in the corporation than to jeopardize the entire election under subchapter S. These considerations limit unnecessarily the attractiveness of election by corporations which must depend upon accumulated income for expanding capital needs.

Except in unusual cases,[124] the problems surrounding previously-taxed earnings would arise in connection with old corporations which have a profit history before electing. New corporations may regard the subchapter S election with much less fear and more trusting acceptance. The personal nature of the previously-taxed earnings account is still a drawback, and attempt should be made to drain off all current taxable income before the year closes. If by error more is withdrawn, the amount would be a nontaxable return of capital, unless the corporation had a pre-election earnings history, or had generated earnings and profits in excess of taxable income.

Summary and Conclusion

For high income investors operating large enterprises, benign tax treatment combines with the private law advantages—chiefly limited liability, centralized management, and continuity of life—to indicate choice of the corporate form. Lower income persons conducting smaller enterprises may find Subchapter S an ideal solution, affording favorable partnership-type tax treatment without exposure to the risk of personal liability. And new business ventures—regardless of size—with expectation of loss in the early years—may find the optimum loss planning formerly available only in the partnership form without sacrificing the limited liability so necessary to the financial security and peace of mind of the investor-entrepreneur.

124. Lourie, *supra note* 114, at 166, calls attention to the possibility that even a corporation not having a history of pre-election earnings might run afoul of the "lock-in" of previously taxed earnings. There are certain items—for example, interest on state and local bonds and the profit element in life insurance proceeds paid by reason of death—which are excluded from gross income, but which still are considered to increase a corporation's earnings and profits for purposes of characterizing a future distribution as a dividend. Treas. Reg. § 1.312-6 (1955).