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TAX FACTORS IN DOING BUSINESS AS A CORPORATION*

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The average businessman today who is considering starting a new business venture normally has several choices of the form in which he will cast his business organization. Broadly speaking, these choices are three: proprietorship, partnership or corporation. In making his choice the businessman must consider a multitude of factors. Not the least of these are the income taxes which he, or his business organization, or both, will have to pay. The time to make this choice is at the outset. If he makes the right choice, the businessman has given his enterprise a good push on the road to success. The wrong choice may plague him all his business life.

Actually the statement that one has a choice of *three* forms of doing business must be somewhat qualified; the emphasis must be on the *average* businessman conducting an *average* sized business. If the business is much above a modest size a sole proprietorship is usually impractical. If the business is to be very large, with the necessity for the use of large amounts of outside capital and wide-spread public ownership, use of the partnership form also becomes impractical. There are some forms of business, such as banking, insurance and the like, which because of the risk element can only be conducted as corporations. On the other hand, some forms of endeavor, such as the practice of law or medicine, cannot by law be conducted as corporations.

Leaving to one side those areas where the type of business, or its size, may direct the form which the business organization is to take, there still remains a large area where the businessman or men who are considering the form of a new venture have a choice of the form in which that venture is to be conducted.

For purposes of the present discussion we will assume that several people intend to combine to conduct the new enterprise. This eliminates the choice of the proprietorship form

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and narrows the field to a choice between a partnership and a corporation. Since our purpose is to examine the income tax impact upon an average sized business corporation conducting an average mercantile or service business, no attempt will be made to treat the income tax problems of certain corporations which receive special tax treatment under the Internal Revenue Code.[1] Nor will it be possible in the scope of this discussion to give any consideration to the tax treatment of corporate reorganizations, recapitalizations, mergers, and the like. All that can be attempted here is to survey briefly the various taxes with which the businessman must contend if the choice is made to do business as a corporation. This will necessarily involve the consideration of taxes laid not only upon the corporation itself but also on the shareholder-owner. The resulting picture from the tax standpoint should then be compared with the tax results of doing business as a partnership. A detailed consideration of the latter subject is also beyond our present scope, but reference will be made at certain points to the tax situation of partnerships for purposes of quick comparison.

WHAT ARE THE TAXES?

At the outset, it may be useful to list the various taxes which will be considered.

So far as the businessman-stockholder personally is concerned, of course, the tax is the income tax to which every citizen is liable.

On the corporate side, however, several different taxes are to be considered: normal tax and surtax, section 11;[2] the capital gains tax, section 1201; special penalty taxes (including the accumulated surplus tax, secs. 531-537, and the personal holding company tax, secs. 541-547); the excess profits tax (now repealed), and state franchise and income taxes.

All these taxes save possibly the penalty taxes, will crop up at one point or another—at the corporation's birth, during its life, or at its death.

1. Thus we exclude the tax treatment of foreign corporations, Western Hemisphere Trade corporations, China Trade Act corporations, foreign personal holding companies, farmers' cooperatives, exempt or non-profit corporations, banks, insurance companies, and regulated investment companies.

2. Except where otherwise noted all references herein are to the Internal Revenue Code, 1954.

WHY CHOOSE A CORPORATION?

We have already assumed that our average businessmen have reached a decision to incorporate. As background, however, and in light of the formidable array of taxes which face the average domestic business corporation, it might be well to recall briefly some of the considerations which lead businessmen to choose incorporation rather than the partnership form for doing business. These are not tax considerations, but are traditionally accepted characteristics and advantages of corporations as opposed to partnerships:

1. The corporation in law is an entity separate and apart from its shareholders. For purposes of doing business it has the rights and powers of an actual person. Like a natural person it can contract, hold property, buy, sell, borrow, loan, sue and be sued in its own right and in its own name.

2. The corporate shareholder normally incurs no personal liability for acts of his corporation. If the corporation becomes liable in contract or in tort, the shareholder does not have to pay. His risk is limited to his investment in the corporation.

3. Corporations can have perpetual existence. Their business can go on for years without interruption or embarrassment because of the death of a stockholder or because of the transfer of stock interests.

4. Interests in a corporation are easily transferable. Everyone knows what a share of stock is. It is easier to buy, easier to sell, and easier to use as collateral for a loan.

5. The corporate form makes it possible to have a large and far-flung organization and still have management concentrated in the hands of relatively few officers and directors. The increased flexibility and efficiency of the corporate management structure makes it preferable to the partnership form.

Any decision to incorporate a business will necessarily have been influenced more or less by all these considerations. While all of them are certainly valid, several observations can fairly be made:

1. In the case of the medium to small business corporation with its stock to be owned by only a few men, some of the supposed advantages listed above are more illusory than real. Thus, a corporation of this sort, in the eyes of the business community, is not likely to be considered as an entity apart

from the stockholding owners. This will result, in many cases, in the shareholders having to assume personal liability in order to promote the corporate business, as in personally guaranteeing corporate obligations.

2. Stock in a small, closely held corporation may prove to be just as difficult to dispose of as a partnership interest, particularly if the stock represents a minority interest in the corporation.

3. The "concentrated management" reason is probably not too important since in a corporation of only a few stockholders concentration has already been achieved.

4. Most of the supposed advantages listed above are now obtainable by doing business as a limited partnership under some form of the Uniform Partnership Act, which has been adopted in practically all states.

TAX CONSEQUENCES OF DOING BUSINESS AS A CORPORATION

We have assumed that several businessmen (let us say, three) who might as well be called Smith, Jones and Brown, have decided that they want to join together to carry on their business, which will be a middle sized commercial, industrial or service business of the type which can either be conducted as a partnership or a corporation. They come to our office. They reveal this background and add that all three intend to be active in the business and that they will each contribute property, money or services in varying amounts. They tell us that they have been discussing among themselves whether to carry on their business as a partnership or a corporation, and that they have about come to the conclusion that they would prefer to incorporate. Before making their final decision, however, they have prudently decided that they should have some expert advice on the tax consequences of this decision.

Our clients already understand in a general way that a partnership as such has no income tax to pay but that each partner will report his individual share of the profits in his personal income tax return. This seems attractive and advantageous to them, since it seems to avoid the danger of the "double taxation" between a corporation and shareholder, about which they heard and read so much in the press. Al-

though for good and sufficient non-tax reasons they have almost concluded that they would rather do business as a corporation, nevertheless they are uneasy about the possibility that they may be letting themselves in for heavy tax burdens and problems which might be avoided by doing business in the partnership form.

Since the best place to start is at the beginning, we tell our clients that we will review for them the various taxes which will face them throughout the prospective life of their corporation, calling attention to some special advantages and pitfalls which may occur along the way.

(a) *Upon Organization*

The tax problems upon organization may fairly quickly be disposed of. There will, of course, be the usual franchise taxes, documentary taxes, and domestication fees. The important consideration from the income tax standpoint is whether or not the incorporation is to be considered taxable or non-taxable. Ordinarily, the incorporation of a new business venture is a non-taxable event. Smith, Jones and Brown will transfer their money or property to the corporation and will receive in exchange therefor corporate stock, more or less in proportion to the value of the property which they have put in, and so long as Smith, Brown and Jones are in control of the newly formed corporation after the transfer, no gain or loss will be recognized to them upon their exchange of money or property for stock (sec. 351). The basis of the property which the corporation receives will be the same for tax purposes as the basis which it had in the hands of the transferors (sec. 362) and the basis of the stock or securities in the hands of the shareholders will be the same as the basis of the property with which they parted (sec. 358).

In connection with such a non-taxable incorporation, however, there is one important difference between the Internal Revenue Code and state law to which we must call attention: stock issued for services is not considered as issued in exchange for "property" within the meaning of section 351. If the incorporation is to retain its non-taxable character, care must be taken that those contributing money or other property have at least 80% control of the corporation after the transfers. Failure to observe this point at the time of incorporation may result in a taxable incorporation with gain (or perhaps loss) being recognized to the shareholders upon the

exchange. In any case, stock received for services will be considered taxable income to the extent of its fair market value when received (secs. 61(a) and 351(d)).

In some cases it may be advantageous deliberately to have a taxable incorporation, as where the incorporators desire gain to be recognized so that the corporation may acquire the assets with a stepped-up depreciation basis, or where the incorporators find it personally advantageous to have a loss recognized upon the transfer. The choice of taxable incorporation, however, is not without its hazards, particularly in the case of the closely held corporation which we are considering. If either Smith, Jones or Brown is to own directly or indirectly more than 50% of the stock of the corporation after the exchange, then any loss on property contributed by him will not be recognized and the benefit will be lost (sec. 267). On the other hand, if any shareholder, together with members of his immediate family, is to own more than 80% of the corporate stock after incorporation, then any gain upon the transfer of depreciable property by him or his family will be treated as ordinary income and not as capital gain (sec. 1239).

(b) *Doing Business*

Once the corporation is underway, and in the happy event that profits are realized, the corporation will have several types of taxes to consider when it comes to make its annual return.

First and foremost, of course, is the normal tax and surtax imposed by section 11, at the rate of 30% of the first $25,000 of net taxable income and at the rate of 52% on all net income above that amount. Here our clients will start making the mental comparison between the tax burdens of the corporate form and the partnership form since, as previously noted, the partnership as such pays no income tax; in this connection there are certain disadvantages and advantages which we can call to their attention.

In the first place, any net operating loss which the corporation may incur may be applied against income in preceding and succeeding years only by the corporation (sec. 172) and not by the shareholder, as would be true in the case of a partner (sec. 702).

The corporation by its nature is denied certain exemptions and deductions which would be available to partners, *viz.* there

are no personal exemptions and no marital deduction, and the corporation's charitable deduction is limited to 5% of its income as opposed to 20% or more for a partner (sec. 170).

On the other hand, we can point out that there are advantages too. If the corporation owns stock in another corporation and receives dividends on such stock, it will pay tax on only 15% of such dividends (sec. 243) whereas any dividends on stock owned by a partnership are includible in full in the gross income of the partners.

In the field of capital gains and losses (sec. 1201) the corporate tax provisions impose a tax of 25% with respect to long term capital gains, comparable to the tax which the partners would have to pay. Here again, however, the shareholder, unlike the partner (sec. 702) cannot take advantage of capital gains from his business to absorb personal capital losses and vice-versa. Further, if the corporation has a capital loss carry-forward, this too cannot be availed of by the corporate shareholder in his personal return but is the exclusive property of the corporation (sec. 1212).

Many states of the union now impose income tax of their own. Those states which have income tax laws impose tax at varying rates on corporations but usually not upon partnerships. Doing business in the corporate form, therefore, may involve the payment of income tax on the whole net income to the home state and, in addition, may involve payment of income tax to other states in which the corporation does business.[3] As to these foreign states an attempt is usually made to tax only that portion of the income which is considered to have been earned within the state's own borders. Such apportionment of income, however, is determined by the various states on the basis of different formulas and the result in the case of a corporation doing business in a number of states may be that because of discrepancies in the formulas used by the various states a corporation will have to pay income tax at the state level on more than 100% of its net income.

Although a few jurisdictions (*e.g.* the District of Columbia) impose an income tax on partnerships conducting a business which can be conducted in corporate form, most states

3. Many states give a credit to domestic corporations which have to pay income tax to other states, but it is not always completely compensatory.

do not impose an income tax on the partnership as such. Thus, the advantages and disadvantages at the state level parallel generally those at the federal level.

Finally, in considering the taxes which the corporation must expect to face from year to year, we must remind our clients of the federal excess profits tax. Since the Sixteenth Amendment to the Constitution was adopted, the federal government has found it necessary on three occasions to impose an excess profits tax on corporate income—in World War I, World War II and the Korean War. Although the tax is now repealed, there is no guarantee that an excess profits tax may not be imposed in the future in the event of a national emergency. The present prospect for increased defense spending in the armaments race with Russia makes this a particularly timely thought. The rates of the excess profits tax, particularly in World War II, were so high—when coupled with the normal corporate income tax and surtax—that many corporations dissolved and converted themselves into partnerships. Although our clients should not base their planning on the assumption that an excess profits tax will be reimposed, they certainly are not justified in ignoring the possibility. No attempt has ever been made to impose an excess profits tax on partnerships.

(c) *Getting the Profits Out—The Double Tax Problem*

Having absorbed this information on the taxes which they will face at the corporate level, our clients very naturally come next to a subject which is near and dear to the heart of every businessman: how to get the profits out of the business, and the tax cost of such a move. This is the area where the impact of federal income taxes at the corporate and individual level makes itself most keenly felt, and provides the clearest illustration of the much discussed "double tax" problem. For in the main, any businessman conducting his affairs in corporate form will find his profits subjected to tax twice between the time it is earned and the time it finds its way into his pocket. By comparison, as previously noted, profits derived from a partnership business are taxed only once, in the partner's individual tax return. The picture is not completely unfavorable, as we shall develop later, but it does provide a potent argument in favor of the partnership form as against the corporate form, particularly in the case of the smaller business and lower individual income levels.

Surveying the situation for Smith, Jones and Brown, we can list for them briefly the tax effects of withdrawing *profits* from the business in the usual accepted ways.

1. Shareholders who perform services for the corporation are of course entitled to compensation, and the payment of salaries, being a deductible item for the corporation (sec. 162), offers the opportunity for transmitting corporate profits to the shareholder with only one tax—the individual's own income tax. There are, however, two principal danger points which must be kept in mind when considering the subject of salaries to shareholders: reasonableness and relationship to shareholdings.

The Internal Revenue Service will always scrutinize the salaries paid by corporations to see that they are reasonable in amount in light of the services rendered. In the case of a non-shareholding employee, of course, there is little incentive for the corporation to pay more than the services are reasonably worth and ordinarily the "reasonableness" controversy will not arise. In the case of employees who are also stockholders, however, the Internal Revenue Service is understandably sensitive to the idea that payments which purport to be salaries may in fact include some element of dividend, and shareholder's salaries are customarily given careful scrutiny by revenue agents. In the case of small, closely held corporations of the type we are considering, the problem is particularly acute. It is safe to say that as many controversies with revenue agents arise upon this point as on any other item involved in the corporate income tax. While the payment of salaries to stockholders does offer a method of avoiding double tax, it must be kept in mind that this is subject always to the limitation that the salaries must be reasonable in light of the services rendered.

The second limitation which must be kept in mind when paying salaries is a precautionary one: it is preferable that the salaries paid not be in the same proportion as stockholdings. While in some cases it may be possible to justify salaries which are proportionately the same as the ownership of stock —on the basis that it just so happens that the value of the services corresponds to stockholdings—nevertheless it can quickly be seen that such a situation is a clear invitation to a revenue agent to leap to the conclusion that the "salaries" are simply disguised dividends.

2. Another method for withdrawing corporate profits with tax at the individual level only is offered by the payment of interest on corporate debt. If, instead of taking only stock in exchange for their transfers of money and property to the corporation, Smith, Jones and Brown take part in stock and part in debt securities, the interest on such securities, being deductible by the corporation (sec. 163) permits the payment of profits to the shareholder with only one tax.

Here again this method, though worthwhile, is subject to limitations and cannot be abused. Our clients must be warned that any debt instruments which they hold must represent a bona fide indebtedness. Interest paid on bonds or debentures issued by the corporation for no consideration will not be allowed as deductions, which rules out the device of distributing dividends in the form of debt instruments, in the hope that interest payments on those debt instruments in the future will be considered deductible.

The next caution which we must give our clients is in the danger of overdoing the issuance of debt as compared to the issuance of stock at the time of the original incorporation. Further comment on this can be reserved until later in this article where corporate financing problems are considered.

3. *Ordinary dividends.* The payment of salaries and interest on debt are all right so far as they go, but we must advise our businessmen that, examining the problem realistically, it is apparent that over the long term the really substantial profits of the corporation will have to be withdrawn by them in the form of dividends on their stock.

It is at this point that the full impact of "double taxation" is felt. For the dollar of profit which is to be distributed as a dividend will first be subjected to the corporate income tax and then to individual tax in the hands of the shareholder. In some cases the resulting combination of tax takes substantially all the profit dollar, and, if state income taxes on both levels are added in, the erosion becomes almost total. To use an extreme example, assuming the present federal corporate rate of 52% and a state income tax rate of 5%, it can be seen that a dollar of profit is immediately reduced to 43¢ before the shareholder receives it. If we then assume an individual shareholder in the highest federal tax bracket, which is 91%, and also assume an individual state income tax of

5%, the shareholder has only 1.7¢ left out of the dollar of corporate profits after all taxes are paid.

It is true that the individual now receives the first $50 of dividend income free of federal tax and also receives a credit of 4% of dividends received against his tax, but these must be considered only token efforts to ameliorate a very serious drawback to doing business as a corporation (secs. 34, 116).

4. *Stock dividends* in lieu of the payment of dividends in cash or property may sometimes be used, and may sometimes be helpful, but the payment of stock dividends does not really solve the problem; it merely defers the payment of tax. Stock dividends are not taxable as income to the shareholder at the time received, but unless the stock dividend consists of common on common, ordinary income tax at the full rate is imposed at the time such stock is disposed of or redeemed. Even in the case of common on common, tax at capital gains rates will have to be paid (secs. 305, 306).

5. The distribution of profits at capital gains rates rather than ordinary income rates is an objective sought by many but achieved by few. Broadly speaking, we must warn our clients that they cannot expect to achieve this result unless they are prepared to liquidate the business in whole or in part, which will involve a withdrawal not only of profits, but a return of capital as well, and the possibility of terminating the entire business. And even if our businessmen are willing to go to these lengths, there is the risk that they may be challenged under the "collapsible corporation" provision of the Code (sec. 341) with the result that most of their would-be capital gains will be taxed to them at ordinary rates.

(d) *Getting the Property Out*

Turning now from the question of withdrawing the profits only and considering the methods by which our clients may withdraw their investment, we are confronted again with difficulties which would not be faced doing business as a partnership. The problem, particularly in a case of a small, closely held corporation, is to avoid paying a tax on what is essentially a shifting of property from one pocket to another. If the incorporators, having put certain money and property into the corporation at the outset, operate for a period of time and come to the conclusion that their corporation is over-capitalized, or that certain specific property no

longer serves any useful corporate purpose, the immediate desire will be to get this investment out of the corporation and back into the hands of the shareholder-investors. The difficulty is that if the corporation has any earned surplus, or if (in the case of property) there has been an appreciation in value, the return of the original investment to the shareholders will be taxed in full as the distribution of an ordinary taxable dividend. Our businessmen may protest vainly that there is no element of profit in such a transaction; that this was property which was theirs in the beginning and which they paid tax to acquire and that all they are seeking is to get their original investment back because the corporation no longer needs it. It will avail them nothing. The full amount of cash distributed and the full value of property will be taxed as an ordinary dividend to the extent that the corporation has earned surplus (or to the extent that the appreciated value of the property is not reflected in surplus). Any amount in excess of this will be applied, first against the shareholders' cost basis in his stock, and when that is exhausted, the excess will be treated as capital gain (sec. 301, 316).

The investor, of course, may get a return of his investment through the redemption of debt securities at maturity or through a complete or partial liquidation of the corporation. In the case of redemption of debt or a complete liquidation, the effects are not too serious, and there will usually be only a capital gains tax on any appreciation in value above the cost of the original investment. A partial liquidation distribution, although technically within the same category as a complete liquidation, will have certain elements of risk, since the Commissioner of Internal Revenue is notoriously averse to partial liquidations and will scrutinize them carefully to make sure that what purports to be a partial liquidation is not simply an attempt to convert an ordinary taxable dividend into a distribution qualifying for the capital gains tax.

In all these cases, the element of double tax is still present. At best, the shareholder will receive back his investment with any appreciation or profit taxable at capital gains rates, but that profit will already have been taxed at the corporate level when it was first made.

Finally, if the corporation has some specific property which the shareholders are anxious to get out they can always repurchase it from the corporation. Even such a seemingly

straightforward transaction as this, however, can have tax problems connected with it. If the purchase price paid by the shareholders to the corporation is too high, the corporation will realize an artificial profit on which it must pay a tax. On the other hand, if the purchase price paid by the shareholder for the property is too low, some enterprising revenue agent may attempt to tax the difference between the purchase price and the fair market value of the property as an indirect method of distributing a taxable dividend to the shareholder. If this would seem to put a premium on being able to guess what some revenue agent may think was a fair price several years after the event, the only answer we can give to our bemused businessmen is that this is just part of the price one pays for doing business as a corporation.

(e) *Reduction or Termination of an Individual Interest*

By this time it is probably apparent that the idea of incorporation is somewhat less attractive to our clients than it was at the beginning of our discourse, and the comparative merits of the partnership form are becoming greater and greater. Having digested what we have said so far with very little pleasure, Mr. Smith now asks us in a strained voice what will happen to him tax-wise if he decides sometime in the future that he is tired of participating in this corporate business and wants to reduce his interest therein or get out altogether.

Since we have assumed in our hypothetical case that Messrs. Smith, Jones and Brown are going to organize the corporation and be its sole stockholders, we point out to Mr. Smith that when he speaks of his "interest", what he is referring to is shares of stock. These shares are all the property he has to dispose of. We can then point out to him that broadly speaking there are two ways to dispose of this stock: by sale, or by redemption by the corporation (including a purchase by the corporation for its own treasury).

If Mr. Smith undertakes to sell all or a part of his stock to an outsider or to another stockholder, ordinarily no particular problem will be involved. It is a straight capital transaction and will qualify for capital gains treatment, long-term or short-term. Mr. Smith's only problem in this case may be in finding someone who is willing to purchase a minority interest in a closely held corporation.

The only danger spot in a transaction such as this is to caution Mr. Smith not to sell to members of his immediate

family if he has a potential loss on the stock, since a loss realized upon a sale to his brothers, sisters, spouse, ancestors, descendants, or to a trust in which he is involved as grantor, fiduciary or beneficiary will probably be disallowed and not recognized for tax purposes under the provisions of Code Section 267.

One further note of caution is in order. If, during the life of the corporation, Mr. Smith has received any "section 306 stock" (*e. g.* a stock dividend of preferred on common) and if later on he undertakes to sell such "section 306 stock", any loss which he sustains will not be recognized for tax purposes and any gain which he may realize will be treated as ordinary income to the extent of his ratable share of the corporation's earned surplus at the date stock was distributed (sec. 306(a)), *unless* Mr. Smith makes the sale to a completely unrelated party and such sale terminates his entire interest in the corporation, including the ownership interests of Smith's relatives.

As noted above, the only alternative to Mr. Smith's selling his stock is to have the corporation redeem it (or purchase it for treasury stock). Here, in the case of stock other than "section 306 stock", a distinction must be drawn between a redemption which eliminates Mr. Smith as a stockholder altogether, and one which merely reduces his interest. If all of Mr. Smith's stock is redeemed there is no problem. He ceases to be a shareholder of the corporation and will realize capital gain or loss upon the transaction.

If he disposes of less than his entire stock interest through redemption, however, the distribution to him will be taxed as an ordinary dividend unless the redemption of his stock was "substantially disproportionate" with respect to the stock of other shareholders which was redeemed, if any, or he must be prepared to show in some other manner that the redemption of a portion of his stock was not essentially equivalent to a distribution of an ordinary dividend (sec. 302).

In the unhappy event that Mr. Smith's stock which is redeemed constitutes "section 306 stock" (see above), then the entire redemption will be treated as ordinary dividend income to the full extent of available corporate earnings (sec. 306(a)(2)) unless: (a) it is a redemption that terminates Mr. Smith's entire interest in the corporation including the interest of his relatives, or (b) the redemption is part of a

partial or complete liquidation of the corporation, or (c) unless he can satisfy the Commissioner of Internal Revenue that such redemption of "section 306 stock" was not made in order to avoid ordinary income tax rates. We can mournfully assure Mr. Smith that the Commissioner will not be easy to convince.

(f) *Terminating the Business*

Our three business venturers seem by now to be pretty thoroughly disenchanted with the idea of a corporation as a means of carrying on their proposed business but, being dogged types, they insist on pursuing the matter to the bitter end. Having surveyed what can befall them tax-wise at the corporation's birth and during its life, they want to know what taxes they and their corporation may be called upon to pay to the Treasury if they terminate the business and dissolve the corporation.

Under a conventional liquidation and dissolution, of course, the corporate business is terminated, liabilities are paid off, assets are liquidated and the remaining balance is paid out to shareholders in redemption and cancellation of their shares. Our clients are all familiar with this sort of thing, but we must point out to them that the tax results of such an ordinary liquidation may be the most expensive of three methods which are offered.

Under the ordinary liquidation and dissolution described above and covered by Code Section 331, the corporation will pay ordinary income taxes on all its business profits up to the time it ceases doing business. As it liquidates its assets it will become liable for capital gains taxes to the extent of any net gain resulting from such liquidation. Finally, when the proceeds are distributed to the stockholders in redemption of their stock, the capital gains tax will fall upon the shareholders individually to the extent they receive more than the cost basis of their stock. Here again it can be seen that the double tax between corporation and shareholder is still present.

The Code provides, however, two alternate methods of liquidation and distribution which in many cases may prove advantageous.

Under Code Section 333, if Smith, Jones and Brown as shareholders adopt an appropriate plan of liquidation and dis-

tribution, and if they make a complete distribution of all corporate net assets within some one calendar month, then the tax results will be as follows:

1. The corporation, of course, will be liable for ordinary income taxes on its business done up to the date the business is terminated.

2. If the redemption of his stock results in gain to the shareholder, then to the extent of such gain, all the corporation's earned surplus which has accumulated since February 28, 1913, will be taxed to the shareholders pro rata as *ordinary income.*

3. The remaining gain, if any, will be taxed to them as capital gain (long or short term) to the extent it is received by the shareholders in the form of cash or securities.

4. As to any remaining property which is not covered by the above two categories and which is received in kind by the shareholders, no tax at the time of receipt will be incurred by the shareholders, but will be deferred until such items are later sold by the shareholders. At the time of such later disposition the gain will be computed on the sale by the shareholders taking as their cost basis the adjusted basis of the stock surrendered by them, decreased by the cash already received and increased by any gain which has already been recognized and taxed to the shareholder in the liquidation.

Here again it may be seen that the deferred tax is present and in an amount actually greater than in the case of the ordinary liquidation described under section 331. The offsetting advantage, however, is that the shareholders are not forced either to make a disadvantageous liquidation of assets at a time when market conditions may be adverse or, alternatively, to receive these assets in kind with the problem of raising cash to pay the tax on them. Instead, the tax on such non-liquid assets can be deferred until they are disposed of later by the shareholders and the cash realized with which to meet the tax.

Another alternative method, which offers many advantages for the small to medium sized corporation, is a liquidation under Code Section 337. Under this method the shareholders adopt a formal plan of liquidation and carry it out so that

within 12 months thereafter all the assets of the corporation are completely distributed. If this is done, no gain or loss to the corporation will be recognized upon the sale or exchange by it of assets during the 12-month liquidation period.

The effect of this provision is simply to allow the corporation to convert its assets to cash without any gain upon such conversion being recognized in the hands of the corporation. To this extent the double tax is avoided (*viz.* the corporation does not have to pay capital gains tax upon the liquidation of the assets with the shareholder paying another capital gains tax when the distribution in liquidation to him is made). The usual corporate income tax, of course, will have to be paid by the corporation up to the time it ceases doing business and to this extent the double tax is still present.

There is one important exception to the above rule: the tax free liquidation provisions of section 337 do not apply to corporate inventory or stock in trade, nor to any installment obligations held by the corporation *unless* (in the case of inventory) the entire inventory and installment obligations acquired in connection therewith are sold to one person in a single transaction.

The above discussion, of course, presumes that the corporate liquidation will result in our shareholders receiving more in the redemption of their stock than their original investment; in other words, that the redemption will result in a gain to them. If the corporate business has not been successful, so that the shareholders receive less in the final wind-up than their original investment, the shareholder may not be able to take full advantage of his loss tax-wise. The loss he suffers upon the redemption of his stock will be a capital loss and he will be able to take advantage of it in the year of the redemption only to the extent that he has capital gains to offset it (plus an additional $1,000 which may be taken as a deduction against ordinary income). Any remaining excess loss can be carried forward as a capital loss carry-forward for the succeeding 5 years by the shareholder but his ability to take advantage of such capital loss (except for the annual amount of $1,000 mentioned above) will depend upon his having some capital gains during those years. This tax advantage (compared with a partnership) is offset by the very real advantage that the shareholder is not personally liable for the losses and

debts of the corporation beyond his investment in the corporate securities.

SOME SPECIAL PROBLEMS

By now we have taken our clients on a quick trip from birth to death of the proposed corporation and have noted for them the taxes which they must expect to confront along the way, both at the corporate and at the individual level. No discussion of the pros and cons of incorporating a business venture would be complete, however, if we did not point out to our businessmen a couple of tax pitfalls in the form of special penalty taxes which they must be careful to avoid; we should also note some tax considerations involved in the question of financing the proposed new corporation. Although a detailed consideration of these subjects is far beyond the scope of this discussion, we must at least call our clients' attention to these matters as a basis for fuller investigation later if appropriate.

(a) *Traps for the Unwary*

In the category of tax pitfalls and penalties there are two principal danger areas which must be mentioned and to which small corporations are particularly susceptible. These dangers take the form of special penalty taxes for certain types of conduct.

The first pitfall is the accumulated surplus tax (secs. 531 to 537). The purpose of the tax is plainly stated. It is framed to apply to every corporation (with a few exceptions) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided or distributed" (sec. 532(a)).

Section 533(a) then provides that " . . . the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders . . . ."

The tax itself is 27½% on the first $100,000 of accumulated income and 38½% on all accumulated income above that amount, and these taxes are imposed on top of the regular corporate normal and surtax.

Although the two Code sections quoted above appear at first glance to state the application of this penalty tax very clearly, closer inspection shows that the language is deceptive. There is no clear standard establishing when a corporation may become liable for this tax. The Code simply states that a corporation shall be liable which permits surplus to accumulate beyond the reasonable needs of the business. What constitutes the reasonable needs of the business is, of course, an area where reasonable-minded men may differ, and so a fertile field for litigation is provided.

It should be pointed out here that this penalty tax is not imposed upon the corporate accumulated surplus itself. Instead the tax is imposed upon "the accumulated taxable income" for the particular year. This phrase, in effect, means the corporation's net taxable income for that year with certain adjustments provided by Code Section 535.

By a specific statutory provision (sec. 535(c)), any corporation is allowed in effect to accumulate at least $60,000 earned surplus before any question as to its liability under this section can possibly arise.

It is easy to see that small, closely held corporations of the type which we are considering are particularly prone to fall into the trap for which this penalty is provided. The shareholders-owners naturally are distressed at the idea of being doubly taxed, first at the corporate level and then when they withdraw the earnings in the form of dividends. If Smith, Jones and Brown are drawing adequate salaries and do not really need dividends from their corporation for their year-to-year living expenses, there is a great temptation for them to let the earnings simply accumulate in the corporation. They will reason to themselves that this is just the same as having the money in the bank and, in addition, it gives the corporation increased working capital. Also, in the back of their minds, may be the thought that if the time ever comes when they need the money the corporation can just declare a dividend; otherwise the accumulated earnings can remain in the corporation until the time comes when they want to sell their stock or until the corporation is liquidated and dissolved. In either case, they think to themselves, they will realize corporate earnings at capital gains rates.

This is exactly the device which the accumulated surplus tax was designed to prevent. Without boring our clients with

the rather tricky questions involving the burden of proof in a controversy involving this tax, which have been put into the 1954 Code (sec. 534), we must caution them of the existence of this pitfall and warn them against the very human temptation to let the surplus of the corporation accumulate beyond the reasonably anticipated needs of the business. It is certainly true that statistically the Commissioner of Internal Revenue has not had outstanding success with the cases he has initiated under these penalty provisions, and this is equally true of this tax's predecessor in the 1939 Code (sec. 102), where the Commissioner did not have the burden of proof. Nevertheless, this tax represents a pitfall which should not be overlooked.

The second major penalty tax trap which must be pointed out is the personal holding company tax (secs. 541 to 547). This again is a danger area to which small, closely held corporations are particularly susceptible, and the penalties are even more severe.

The tax itself, which again is imposed on top of the regular corporate normal and surtax, is 75% of the first $2,000 of undistributed personal holding company income and 85% on the balance — practically confiscatory.

In order to fall into this trap two requirements must be met:

(a) 80% or more of the corporate gross income must be "personal holding company income" and, at the same time,

(b) over one-half the outstanding stock of the corporation must be owned by or for not more than 5 individuals at some time during the last six months of the year (sec. 541).

Here again we need not and cannot go into a detailed discussion of all the ramifications of this special penalty tax. By now Smith, Jones and Brown are probably so glassy-eyed they could not absorb it anyway. The important thing to bring to their attention at this time, when they are contemplating whether or not to incorporate, is that such a penalty tax does exist; that in the first instance at least, their corporation will qualify, as not being owned by more than 5 individuals, so that they must be particularly careful not to run afoul of the second requirement of having more than

80% of their gross income classified as personal holding company income.

The statute (sec. 543) specifies just what is personal holding company income. Broadly speaking, it includes most of those types of income which are not the result of goods or services originating with the corporation itself. The biggest hole in this tax net is the fact that rent *is* considered personal holding company income unless such rent constitutes 50% or more of the gross income of the corporation, in which case rent is *not* considered personal holding company income. This exception makes it possible to have fairly inactive real estate holding or management companies without falling afoul of the tax. In the case of our three clients, we have assumed that no such business was to be followed. The principal danger is that in bad business years, when normal corporate income from the sale of goods or services has fallen off, "personal holding company" types of income may creep up to the 80% mark without anyone paying attention to it. If such a thing should happen the corporation will have to pay out practically all of its income in the particular year in order to avoid the penalty tax (secs. 545, 547 and 561), even though under standards of sound business management such action would be unsound.

(b) *Tax Considerations in Corporate Financing*

Assuming a decision to incorporate, the immediate question which presents itself is: How shall the corporation be capitalized? That is, shall there be stock of more than one class and, if so, what shall the rights and privileges of those various classes be? Again, shall there be debt incurred as part of the original financing and, if so, how much? Is it better to be ultra conservative in capitalizing the corporation in the first instance or should the emphasis be on ample capitalization to cover all contingencies? Finally, given a choice of certain assets which the incorporators might or might not want to put into the new corporation, which assets should be taken in and which should be avoided?

Obviously, all these questions involve considerations and principles which have nothing to do with taxes. Indeed the final answer as to any one of them may be determined by important considerations which bypass the tax aspect entirely. It is not our purpose here to go over with Smith, Jones and Brown all those reasons involving sound corpora-

tion capital planning which are not tax reasons. We should, however, point out to them that each one of these questions has its tax side and, in addition to the other things which they must consider, our businessmen must give consideration to the tax effects of the various choices which are presented.

Purely from the tax standpoint, we should point out that in organizing the corporation, moderate amounts of debt may be preferable to the creation of preferred stock. The principal reason for this is the old double tax reason: dividends on preferred stock are not deductible from income by the corporation whereas interest on bona fide debt would be (see discussion *supra*). This has particular importance in the case of preferred stock where dividends at a fixed rate accrue year in and year out.

On this question, however, the emphasis must be on the word "moderate". A newly formed corporation which elects to create long term debt rather than preferred stock may derive legitimate tax advantage only if the process is not overdone. Where the ratio of debt to capital stock becomes excessively large there is danger that the Commissioner may classify the corporation as "thin" and refuse to recognize the debt as a true obligation of the corporation, with the result that interest on such debt will not be allowed as deductions.[4]

In deciding whether or not corporate debt constitutes true indebtedness so as to make interest deductible, the Commissioner will look not only to the ratio of debt to capital but will employ several other tests. He will look to see whether this "debt" is subordinated to all other debts of the corporation — past, present or future. He will examine the bonds or debentures to see whether or not there is a fixed rate of interest. He will look to see whether the evidences of indebtedness have a fixed maturity date and whether or not they represent an unconditional obligation of the corporation to pay the face amount in all events. He will look to see whether or not the holders of such indebtedness have any voting rights.[5]

No one of these various tests will be conclusive, but all will be considered, including the ratio of debt to capital, and if the Commissioner determines, after considering all the factors, that the "debt" instrument in question has less of the

4. See Sunswick Corp. v. U. S., 58-1 U.S.T.C. ¶9292 (S.D.N.Y. Feb. 14, 1958); John F. Douglas, CCH Dec. 22, 881(M), 17 TCM 143 (1958).
5. See Texoma Supply Co., CCH Dec. 22, 882(M), 17 TCM 147 (1958).

characteristics of debt and more of stock, he may determine that what purports on its face to be a loan was really an equity investment with the result that he will disallow the "interest" payments as corporate deductions.[6]

The question of conservative or liberal capitalization is closely tied to the points mentioned above. If there is too little capitalization compared to debt, the corporation runs the danger of being called "thin". On the other hand, there can be serious disadvantages in going to the other extreme and putting too much investment into the new corporation. If assets are put into the corporation in exchange for stock, either at the time of incorporation or later, and if thereafter it is determined that the corporation does not need these assets and the shareholders would like to get them back, it will be impossible without the full value of the asset being taxed to the shareholder as an ordinary dividend or, at the very least, with some capital gains tax upon a partial liquidation (see the previous discussion under *Getting the Property Out*). And if the corporation sells the unwanted asset rather than returning it to the shareholder or shareholders, a capital gains tax is incurred which could have been avoided if the asset had not been put into the corporation in the first place. Furthermore, the proceeds of such sale, if distributed thereafter to the shareholder, will be considered ordinary, fully taxable, dividends.

Assuming a choice of assets which may or may not be put into the corporation, there are a few tax considerations which our businessmen should keep in mind in making their selection.

Other things being equal, or even approaching equal, it will usually be advantageous to put into the corporation good dividend paying stocks in other companies, since the dividends on such stocks in the hands of the corporation will be entitled to the dividends received deduction of 85% (sec. 243) which would not be available if the stocks were retained in the hands of the individual shareholders.

Again, assets which are to be used in the trade or business and which the incorporators think may be sold later at a loss, might well be transferred to the corporation in a non-taxable exchange. The existence of such a potential loss, which the

6. *Cf.* Northline Realty Corp., CCH Dec. 22, 839(M), 17 TCM 98 (1958).

corporation may realize at its option, gives some measure of protection against the imposition of the penalty tax on unreasonable accumulations (secs. 531-537).

On the other side of the picture, there are several types of assets which, purely from the tax standpoint, Smith, Jones and Brown should avoid putting into their new corporation. Among these will be assets which have appreciated in the hands of the shareholders and which are to be put into the corporation in a non-taxable exchange for stock. The reason is obvious: upon the subsequent sale of the asset by the corporation the double tax problem immediately presents itself.

For the same double tax reason it is preferable not to put into the corporation interest bearing bonds, since the corporation has no "dividends received" credit in the case of bond interest.

In the case of tax free obligations (*e. g.* state or municipal bonds), the shareholders would do well to retain them in individual ownership. While it is true that the interest received on such obligations would be non-taxable to a corporate owner just as to an individual owner, the problem is that such non-taxable interest, once received by the corporation, loses its non-taxable character and upon subsequent distribution to the shareholder would be taxed as an ordinary dividend.

In line with the previous discussion concerning the special personal holding company tax, it would be well to avoid putting into the new corporation assets which are likely to produce personal holding company income in dangerous amounts.

Finally, if the business of the corporation is going to involve the use of any patents, trade marks or copyrights, it would be preferable from the tax standpoint not to put these assets into the company directly but to allow the company to have the use of the invention or process covered thereby on a lease or royalty basis. If this can be done, royalty income in reasonable amounts can be paid to the shareholder with the imposition of only one tax, on the individual level.

CONCLUSIONS

We have now taken our clients swiftly down the corporate tax road, pointing out for them briefly the various types of income tax they may expect to encounter in all phases of the ordinary conduct of their business and a couple of taxes which

they may be unfortunate enough to encounter in extraordinary situations. So far as Smith, Jones and Brown are concerned, all the news seems to be bad. We have talked and talked and talked about taxes and yet more taxes, practically all of which seem to apply to corporations and practically none to partnerships. We have pointed out a number of other tax problems in the incorporation, dissolution and distribution of assets in a corporate business. All we seem to have done is to run down the idea of incorporation, and after this doleful discourse is ended, our clients may and probably will want to know why any sane person would think of doing business as a corporation under any circumstances.

This may be a very natural reaction after all we have said, but it is nevertheless a little overdone. The coin is not altogether one-sided.

Purely on the basis of tax dollars to be paid out, one can make a pretty plausible argument that the small to middle-sized business is better conducted as a partnership than as a corporation. Unless the net income of the business (before salaries to shareholders or partners) exceeds $200,000, the combined cost in taxes to the corporation and the individual shareholders will probably exceed the tax which partners would pay upon the same amount of income. In this connection, Table A (following the end of this article) presents a comparison of these combined tax costs of corporations and shareholders on the one hand versus partners on the other, at various levels of net income, assuming that other factors are constant. From this table it may be seen that somewhere between the $200,000 and $300,000 level of business income, the balance shifts and it becomes relatively more favorable to do business as a corporation.

The reason for this is quickly apparent. By the time the $300,000 level of net business income has been reached in a partnership, a level of personal income has been reached which calls for a personal income tax bracket well in excess of the maximum corporate rate of 52%. Since all the business net income must be reported every year by partners whether distributed to them or not, the result is that doing business as a partnership in large business enterprises simply results in boosting the partners into the highest possible brackets so that they wind up paying higher taxes than they and their

corporation would pay if the business were conducted as a corporation.

A strong case therefore can be made for the incorporation of a larger business. There is the further consideration that for individuals who are, or expect to be, in high brackets anyway because of outside income, incorporation may be absolutely necessary because as partners their high individual tax bracket would prevent their business from accumulating any surplus or additional working capital: substantially all the profits would have to be withdrawn by the partners each year in order to meet their heavy income tax burden unless, of course, the individual partners had such ample outside resources that they could meet their large tax liabilities without withdrawing partnership profits. For such high bracket individuals the corporation, with its maximum surtax rate of 52% offers an opportunity to retain earnings and grow which is denied to them as partners.

All this, of course, applies only to the high bracket individual and the larger business. For the small to middle-sized business which has been the subject of our discussion these conditions will not be important, and as Table A indicates, the tax cost of doing business as a corporation will be higher than the partnership cost.

As in most tax questions, however, the answer is not simple and clear cut. We cannot simply say that it is better to do business as a partnership at a net income under $200,000 and better to incorporate at a larger figure. The reason is that in the tax field things are not always as they seem, and the business organization which on its face purports to be one thing may find itself being taxed as something quite different. If our clients, frightened by all that we have told them about corporate taxes, rush out and form a partnership instead of their contemplated corporation, but carry on their partnership business in a fashion which is more akin to a corporation than it is to a partnership, there is the danger that the Commissioner may attempt to tax the partnership as a corporation. Section 7701(a) (3) of the Code defines "corporations" for tax purposes to include associations even though unincorporated. Likewise section 7701(a) (2) defines partnerships to include everything but trusts, estates and corporations. Thus the definition of business organizations for tax purposes may not necessarily be the same as the definition for general or

common law purposes. In this area the Commissioner is liable to adopt the old rule of thumb that something that looks like a duck, walks like a duck, and quacks like a duck, shall be taxed like a duck, regardless of the name which is attached to it. If a "partnership" is so set up or so conducted as to have most of the attributes of a corporation there is danger that the Commissioner may determine that it should be taxed as a corporation. Among these attributes which may cause the Commissioner to look behind the partnership form are:

(a) Continuous life of the partnership regardless of the death of a member

(b) The limited liability of partners

(c) Free transferability of partnership interests

(d) Centralized management under a proportional voting or majority rule system.

It is no answer to this to say that all of the above characteristics or most of them may now be had in partnerships in various states under their uniform partnership acts for, as we have pointed out, the Commissioner of Internal Revenue is not necessarily bound by the classification of business enterprises for local law purposes and he will be inclined to tax the business organization according to whether he thinks it more closely resembles a partnership or a corporation.[7]

In sum then, we can only conclude that although it may well be true, broadly speaking, that many small to middle-sized business enterprises would be better off tax-wise to do business as a partnership rather than as a corporation, still the ultimate decision is one that will have to be made independently in every case. It will necessarily involve balancing the financing and management advantages inherent in corporations against the probability that the tax cost to corporation and shareholder combined will be larger than the cost of doing business as a corporation.

7. *Cf.* Elmer Irvin Trust, 29 TC—, No. 91 (1958); John I. Cooper, CCH Dec. 22, 863(M), 17 TCM 127 (1958).

TABLE A

Comparison of Federal Income Taxes Payable Upon Income of Business as a Corporation and as a Partnership: Assuming No Corporate Excess Profits Tax and Assuming No Corporate Dividends Would Be Paid.

Net Business Income (before Shareholders' Salaries)	*Shareholders' Salaries*	*Total *Individual Taxes on Salaries*	*Corporate Income Tax*	*Potential Capital Gains Tax on Surplus Retained by Corporation*	*Total Taxes of Corporation and Shareholders*	**Total Taxes on Individual Partners' Shares*
$ 30,000	$ 21,000	$ 4,116	$ 2,700	$ 1,575	$ 8,391	$ 6,288
50,000	30,000	6,288	6,000	3,500	15,788	12,033
75,000	36,000	7,848	14,780	6,055	28,683	21,174
100,000	45,000	10,500	23,100	7,975	41,575	32,601
200,000	75,000	21,174	59,500	16,375	97,049	91,182
300,000	100,000	32,601	98,500	25,375	156,476	160,056
400,000	120,000	42,924	140,100	34,975	217,999	236,181
500,000	150,000	60,192	176,500	43,375	280,067	317,112

*Assuming Three Partners or Shareholders, Each Married, with Two Dependent Children, and Each with $3,000 Outside Net Income, and Each One Entitled to One-Third of the Salary or One-Third Partnership Share.