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# Initial Decisions Confronting the New Corporation

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## INITIAL DECISIONS CONFRONTING THE NEW CORPORATION

PROFESSOR LLEWELYN:

The decision-making process for a new corporation amounts to a great deal more than simply cataloging all the available tax advantages and then systematically selecting those for which the corporation can qualify. One soon discovers that by making one decision, the corporation often forecloses the opportunity to make another even where the two would seem to be compatible. And as always, we must remember that tax decisions cannot be made without considering the other consequences that will ensue. Due considerations must also be given to the Commissioner's arsenal for combating what may appear to be on the surface an obvious opportunity to procure a tax advantage. It was in that spirit that Professor Charles Lyons of New York University formulated the rule that in the tax law if something appears too good to be true, it isn't.

In spite of the fact that many of the tax decisions to be made are inextricably bound together, it is useful for organizational purposes to make some attempt to separate at least the major areas involved. Foremost is the decision whether to be taxed as a corporation or a quasi-corporation, commonly called a subchapter S corporation, which in many respects, but not all, is taxed as a partnership. A similar kind of noncorporate shareholder status can be elected under section 1244 for the treatment of losses on stock experienced as a result of a corporate failure. Both subchapter S and 1244 have reached age 15. It has been said that the difference between them is that if you fail in an attempt to qualify for subchapter S treatment, you receive a penalty of half the distance to the goal; but if you miss qualification of 1244, *all* you lose is the down.

### SUBCHAPTER S

The enactment of subchapter S was in pursuance of two goals:

1. "Small corporations which were essentially partnerships were to enjoy the advantages of the corporate form of organization without being made subject to the possible tax disadvantages of the corporation," and
2. "The elimination of the influence of Federal Income Tax in the selection of the form of business organization which may be most desirable under the circumstances."<sup>1</sup>

The first objective was realized substantially for some small, uncomplicated corporations. With 10 or fewer shareholders, all of whom were either individuals or estates. Even then, the corporation could not

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<sup>1</sup>S. Rep. No. 1622, 83rd Congress, 2nd Session, p. 119 (1954); S. Rep. No. 1983, 85th Congress, 2nd Session, p. 87 (1958).

receive for such year passive investment type receipts, called "passive investment income," in excess of 20 percent of gross receipts.<sup>2</sup> The passive investment income requirement alone eliminates the very common small rental corporation from electing subchapter S treatment, unless it can be shown that significant services are performed to such an extent that the receipts will be classified as active business income rather than passive rent.<sup>3</sup> The distinction is made between payment for more space as contrasted with payment for space and service. The classic illustration is to contrast the hotel or motel operation which is considered active business income with the leasing of apartments or offices which is considered passive rental income.<sup>4</sup> Two aspects of the passive investment income test should be emphasized. First, the 20 percent test is made by comparing passive income with gross receipts.<sup>5</sup> Therefore, a loss corporation having some passive income will not be disqualified. Second, the passive investment income test is not applied to a new business in its first two taxable years provided its passive investment income is less than \$3,000.<sup>6</sup> This exception was designed to protect a new corporation from disqualification because its principal source of income was derived from interest on working capital not yet put to use in the business.

Even if the corporation qualifies for subchapter S treatment, not all of the corporate tax disadvantages are removed. It took a long time for some lawyers and accountants to become aware of the Lorelei-like quality of subchapter S which can trap the uninitiated. For instance, one of the most appealing aspects of a subchapter S corporation from a tax planning point of view, is the ability to parlay the fact that the shareholders of a subchapter S corporation are treated like partners for purposes of reporting subchapter S income<sup>7</sup> (that is, they report the income in the taxable year in which the subchapter S year ends) with the fact that, unlike a partnership, the subchapter S corporation does not have to have the same taxable year as the principal shareholders.<sup>8</sup> Therefore, if the corporation has a fiscal year ending on June 30 and the shareholders have a calendar year, the corporate income earned from July to December may be postponed for reporting purposes for a period of one year. But if that income be distributed, the shareholders, unlike partners, must report that income in the year received. A distribution from a subchapter S corporation is to the extent of current earnings and

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<sup>2</sup>I.R.C. §§ 1371(a), 1372(c)(5).

<sup>3</sup>See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (3rd ed., 1971), §603, note 31 at 6-14 for rulings that various receipts did not constitute rents.

<sup>4</sup>*Id.*

<sup>5</sup>I.R.C. § 1372(c)(5)(A).

<sup>6</sup>I.R.C. § 1372(c)(5)(B).

<sup>7</sup>I.R.C. § 1373(b).

<sup>8</sup>Subchapter S does not contain a provision like I.R.C. § 706(b)(1) of subchapter K.

profits a dividend in the taxable year in which it is received.<sup>9</sup> Incidentally, at the time such a distribution is received, there is no way of knowing the income tax consequences. That determination must await an earnings and profits calculation made at the end of the corporation's taxable year, a period beyond the time fixed for filing the individual return. In addition, although a subchapter S corporation has the income pass-through features of a partnership, unlike a partnership, items such as dividends, interest, and short term capital gains do not retain their character and are taxed to the shareholders as undifferentiated ordinary income.<sup>10</sup>

Prior to 1969, this dual partnership corporation nature of subchapter S was very appealing, particularly with respect to the participation by shareholder-employees in fringe benefits such as pension and profit-sharing plans, employee death benefits, accident and health plans, group term life insurance, and stock options. The tax benefits of qualified plans were somewhat neutralized by the enactment in 1969 of section 1379 which imposed H.R. 10 limitations on shareholder-employees, defined as shareholders owning over five percent of the corporate stock. However, subchapter S plans are still preferable to H.R. 10 plans.<sup>11</sup> For instance:

1. Under an H.R. 10 plan, contributions on behalf of a self-employed person in excess of the lesser of 10 percent or \$2,500, unless repaid, disqualify the plan.<sup>12</sup>
2. Under a subchapter S plan, although the contributions in behalf of a shareholder-employee that exceed 10 percent or \$2,500 are treated as income to the shareholder, these excesses are regarded as his contribution to the plan and the earnings on these contributions inure to his benefit and are not required to be included in his income tax return.<sup>13</sup>
3. A shareholder-employee is treated like any other employee for a capital gains treatment on lump sum distributions.<sup>14</sup>
4. Also, the averaging rules for lump sum distributions that don't qualify for capital gains treatment are more favorable under subchapter S plans than under an H.R. 10 plan.<sup>15</sup>
5. There are no penalty provisions for premature distribution under subchapter S as with H.R. 10.

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<sup>9</sup>Reg. 1.1375-4(b). Current earnings and profits are first applied to distributions which are not distributions of the corporation's undistributed taxable income for the immediately preceding taxable year under section 1375(f). A distribution of previously taxed income may occur only if during its taxable year, the corporation makes money distributions in excess of its earnings and profits for such taxable year.

<sup>10</sup>Compare I.R.C. § 702 with I.R.C. §§ 1373 and 1375.

<sup>11</sup>Pennell, *New Law Necessitates Fresh Look at Qualified Plans of Sub S Corporations*, 32 J. TAXATION 164 (1970).

<sup>12</sup>I.R.C. § 401(e).

<sup>13</sup>I.R.C. § 1379(b).

<sup>14</sup>I.R.C. § 402(a)(2) denies capital gain treatment to a self-employed person.

<sup>15</sup>I.R.C. § 72(n)(4).

**MAX-TAX**

Section 1348, inserted by the 1969 Reform Act, provides for a 50 percent maximum tax on earned income. Prior to this provision, the unreasonable compensation problem in subchapter S was often the reverse of the non-electing corporation. This was due to the fact that subchapter S income was taxed at the same rate to the individual whether it came out as salary or as a share of undistributed taxable income. Therefore, the concern of the Service with compensation was in connection with reapportionment of distributions of undistributed income among family members, where it was determined that it was necessary to truly reflect the uncompensated value of services of a shareholder to a corporation.<sup>16</sup> Although it is generally agreed that 1348 benefits are more illusory than real, it may have to be considered in fixing compensation in a subchapter S treatment. It may even militate against operating in corporate form because operating as a corporation may open up unreasonable compensation problems that would not be present if an unincorporated status was retained.

The second objective of subchapter S — the elimination of Federal income tax from the considerations weighed in the selection of a form of business organization — was certainly not realized unless it is viewed in terms of restricting the subchapter S provisions to corporations with very uncomplicated capital structures. Such a restriction is reflected clearly in the one class of stock requirement of section 1371. This requirement obviously was intended to prevent the taxation of each shareholder under the conduit theory from becoming unduly complicated as a result of the introduction of preferred stock.<sup>17</sup> As a result of this restriction, any attempt to provide for a senior or preferred type return on a capital contribution, and at the same time preserve subchapter S eligibility, must be implemented through the use of debt. Where a senior return is desired on a substantial amount of capital, the attempt to provide for it through debt may result in thin incorporation problems. The thin incorporation problem, in spite of what some commentators may say, does exist with respect to a subchapter S corporation.<sup>18</sup> Although it is true that many of the debt advantages present in a non-electing corporation are neutralized in a subchapter S corporation, a subchapter S election may terminate at any time. A thin incorporation attack on a subchapter S corporation results in double trouble because a reclassification of the debt as equity could result in a finding of a second class of stock, thereby disqualifying subchapter S treatment.

In recent years there has been considerable development on the question of reclassifying debt as a second class of stock. The regulations once provided

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<sup>16</sup>I.R.C. § 1375(c).

<sup>17</sup>McGaffey, *The Requirement That a Subchapter S Corporation May Have Only One Class of Stock*, 50 *MARQ. L. REV.* 365 (1966); Sen. Rpt. No. 1622, 83rd Congress, 2nd Sess. 119, 453 (1954).

<sup>18</sup>*Shareholder Lending and Tax Accounting of a Subchapter S Corporation*, 67 *COLUM. L. REV.* 495 (1967).

that debt which was reclassified as equity constituted a second class of stock. In 1966, the Tax Court held that these regulations were beyond the scope of the Treasury authority because not every debt that was reclassified as equity could be considered another class of stock.<sup>19</sup> The Tax Court was referring to the situation where the debt was held pro rata. This resulted in the regulations being rewritten to concede that if the purported debt were held pro rata by the shareholders on reclassification, the "debt" would be treated as a contribution to capital and not stock.<sup>20</sup> In the *Stinnett* case, presently on government appeal in the Ninth Circuit, the Tax Court invalidated the revised regulations and held that where there is substantial disproportion in holdings of debt and stock, notes reclassified as equity should not be classified as a second class of stock for subchapter S purposes.<sup>21</sup> The Court of Appeals for the Fifth Circuit has held the regulation invalid.<sup>22</sup> However, the Seventh Circuit in a recent case upheld the validity of the regulations and reclassified the non-pro rata debt as a second class of stock.<sup>23</sup> Until this question is settled, the tax planner must regard the regulation as valid, thus placing him in a dilemma. If he uses debt as a form of providing a senior return on capital in order to preserve subchapter S eligibility, unless the debt is pro rata (a strong indicator that it is equity rather than debt), reclassification of the debt as equity may result in a second class of stock and terminate the subchapter S election. This will then cause a re-determination of income tax consequences that could include several taxable years.

Another area where the one class of stock rule has been applied occurs where differences in voting rights result from voting trusts or shareholder agreements.<sup>24</sup> Such a position cannot be justified on the grounds that the one class of stock rule is necessary to prevent accounting problems of allocating income when the stockholders have varying rights. The Tax Court has so held in cases involving voting trusts.<sup>25</sup>

There have been several suggested changes aimed at alleviating this one stock requirement. The Treasury submitted proposals to the Ways and Means Committee in 1969 whereby a debt which had a fixed interest rate, a fixed redemption price, and no voting rights would not be treated as a second class of stock if reclassified as equity.<sup>26</sup>

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<sup>19</sup>W. C. Gammon, 46 T.C. 1 (1966).

<sup>20</sup>Reg. § 1.1371-1(g).

<sup>21</sup>Stinnett Jr., 54 T.C. 221 (1970).

<sup>22</sup>Amory Cotton Oil Co. v. U. S., 72-2 U.S.T.C. 9714 (1972).

<sup>23</sup>Portage Plastics Co., Inc. 72-2 U.S.T.C. 9567 (1972) rev'g 69-2 U.S.T.C. 9593, 301 F. Supp. 684 (1969).

<sup>24</sup>Rev. Ruling 63-226, 1963-2 CUM. BULL. 341.

<sup>25</sup>Parker Oil Co., 58.95 P-HTC (1972); for a decision supporting the Tax Court's position on voting power, see A & N Furniture and Appliance Co., 271 F. Supp. 40 (D.C. Ohio 1967). *But see* S. Pollack, 392 F.2d 409 (1968).

<sup>26</sup>2 U.S. TREASURY DEPT. TAX REFORM STUDIES AND PROPOSALS 271 (Comm. Print 1969).

Incidentally, the same proposals would:

1. under certain conditions increase the number of permissible shareholders from 10 to 15,
2. permit stock to be held by a voting trust,
3. repeal the passive investment income limitations, and
4. require that the taxable year of the 10 percent shareholder and the corporation coincide, or else the corporation would have to select a calendar year.

### DEBT OR EQUITY

The basic question of when debt is vulnerable to reclassification as equity should be resolved on the basis of the creditor's expectation of payment on the specified terms and on the corporation's ability to repay the obligation out of expected cash flow, expendable assets, or other sources that are not entirely dependent on the success of the business. A mechanical task such as the debt-equity ratio test should not be regarded as a substitute for these ultimate findings. Unfortunately, tax lawyers and accountants have permitted certain specified ratios of debt to equity to become an article of faith. How many times have you heard it said that a four to one debt to equity ratio would assure that the debt would not be reclassified as equity? The confidence that lawyers and accountants have for such statements stems from the proposed safe harbor proposals offered by the American Bar Association<sup>27</sup> which advocated a 10 to one debt to equity ratio, and the advisory group on subchapter C<sup>28</sup> which proposed a five to one ratio. Those proposals seem to be more in the nature of tax incentives to shareholders of close corporations than reasonable standards. At least one commentator has suggested that the Treasury in adopting regulations pertaining to this question under the mandate of the new section 385 should fix a conservative debt-equity ratio of two to one.<sup>29</sup> This would be done as a means of establishing outside limits for a safe haven, thereby leaving the reclassification of debt above that ratio to be determined on the basis of the ultimate test suggested earlier. To reiterate, that test was based on the expectation of the creditor to be repaid in accordance with the specific terms, and the ability of the corporation to make the payment from sources that are not entirely dependent upon the success of the business. When the inquiry is put in these terms, the suspicion that courts have for debt issued for the transfer of operating assets is easily understood.<sup>30</sup>

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<sup>27</sup>See Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 580 (1971).

<sup>28</sup>See Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1 (1958).

<sup>29</sup>See note 27, *supra* at 610.

<sup>30</sup>R. C. Owen Co. v. United States, 351 F.2d 410 (6th Cir. 1965); Gokey Properties, Inc. 34 T.C. 829 (1960), *aff'd.*, 290 F.2d 870 (2nd Cir. 1961).

## OUTSIDE DEBT

In formulating a debt-equity ratio, should debt issued to nonshareholders be ignored? The American Bar Association proposal for a 10 to one debt-equity ratio ignored all outside debt, including debt guaranteed by shareholders.<sup>31</sup> The advisory group proposal excluded outside debt unless guaranteed by a shareholder.<sup>32</sup> It will be a rare close corporation that will have outside debt not guaranteed by a shareholder. Such guaranteed debt may be reconstructed by the Commissioner to be the debt of the shareholder rather than the debt of the corporation. If the Commissioner prevails in that disastrous position, the shareholder guarantor will be regarded as receiving the proceeds of the loan, making a contribution of the proceeds of the loan to the capital of the corporation. Then each time the corporation makes a payment on the loan, it satisfies the legal obligation of the shareholder and thereby constitutes a dividend. The corporation would be denied an interest deduction, but one may suppose that the shareholder should receive an interest deduction. Such a reconstruction often conforms to the reality of the situation with respect to a close corporation, but such a conclusion should not follow from the mere fact that the financial institution insists upon such a shareholder guarantee. Such insistence by the financial institution might simply signify a desire to encourage the shareholder to put forth his best efforts to achieve corporate success, at least through the period of the loan. It has also been suggested that such insistence on a shareholder guarantee may be explained as a simple substitute for a complicated indenture to ensure the impairment of the corporate assets by the payment of salaries or dividends.<sup>33</sup> The true nature of the ostensible guarantor arrangement should be determined on essentially the same basis suggested for resolving problems of debt/equity reclassification. In other words, the true arrangement depends on the expectation of everyone including the financial institution and the shareholder concerning the ability of the corporation to pay off the loan from cash flow or non-essential assets of the corporation without unduly relying on the success of the business. Moreover, the form of the shareholder guarantee be it guarantor, co-maker or endorser should make no difference, nor should the inclusion of the normal remedial provision such as the right to proceed against the guarantors without exhausting the remedies against the corporation.

Professor Herwitz of Harvard University illustrated all the concepts discussed above and some others that will be discussed later by applying them to the incorporation of the fictitious Her-belt Company.<sup>34</sup> The Her-belt

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<sup>31</sup>See note 27 *supra*.

<sup>32</sup>See note 28 *supra*.

<sup>33</sup>See note 27 *supra*.

<sup>34</sup>See discussion in HERWITZ, *BUSINESS PLANNING*; Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Closely Held Corporation*, 75 *HARV. L. REV.* 1098 (1962).

Company was conducted by a sole proprietor and incorporation was proposed as part of a plan to bring into the business a valuable employee with no money, and at the same time to attract the capital of the employee's father-in-law, who had no desire to work in the business. The father-in-law and son-in-law each wanted to receive approximately 25 percent of the control and earnings of the corporation with the remaining 50 percent control and earnings share going to the former sole proprietor who would also work in the business. The problems presented in this situation are fairly obvious. In order to achieve the desired split in the control and the normal earnings and equity, the common stock had to be proportioned 25 percent to son-in-law, 25 percent to father-in-law, and 50 percent to proprietor. Since the son-in-law had no money, and to avoid the problems of issuing stock for services, it was necessary that the total common stock offering be restricted and issued in return for a small portion of the assets transferred to the corporation. The issuance of stock for services not only causes an income realization problem for employees, but will destroy 351 treatment unless the employee transfers some money or property to the corporation.<sup>35</sup> In addition, the issuance of stock for services causes 1244 problems discussed later. Such a severe limitation on the amount of common stock to be issued meant that a rather substantial portion of assets transferred to the corporation by father-in-law and proprietor required some senior security in return. In order to meet the one class of stock requirement for subchapter S treatment, one might be tempted to risk a very thin incorporation and issue only debt obligations for the assets which were transferred in excess of the common stock. This is no small risk due to the likelihood of the debt being reclassified as a second class of stock and the loss being suffered. Note that not only would such a capitalization be vulnerable to the debt-equity ratio test, but in addition, the debt issued to the sole proprietor would be issued for working assets making the debt even more vulnerable to reclassification. In the face of such substantial risks, it might be better to forego qualifying for subchapter S and face up to the pressing need for some type of preferred stock in this situation. After all, there are other ways to avoid tax at the corporate level, such as the payment of compensation to shareholders or a rental arrangement with a shareholder in lieu of transferring business property to the corporation. Also, it is possible that, depending on the shareholder tax bracket, the tax arithmetic may very well work out in favor of the section 11 tax rather than subchapter S treatment. It must also be noted that the initial decision on the issuance of preferred stock is crucial because that is virtually the only time that preferred stock can be issued without the fear of section 306 treatment.<sup>36</sup>

### TAXATION OF ORDINARY INCOME

Some care must be exercised with respect to the mechanics of the actual corporate election of subchapter S. That election must be made in the first

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<sup>35</sup>Reg. § 1.351-1(a)(1)(ii).

<sup>36</sup>I.R.C. § 306.

month of the corporation's taxable year. The regulations provide that "the first month of the taxable year of a new corporation does not begin until the corporation has shareholders or receives assets or begins doing business, whichever is first to occur."<sup>37</sup> It is possible that the election may be too early or too late. Suppose a corporation is quickly formed to preserve the name, but some additional thought must be given to capitalization and other problems. While those questions are being resolved, one of the incorporators opens a checking account and writes a few checks for some promotional work or advertising that was done on behalf of the corporation. Is that "doing business?" Who knows what the Service may consider doing business? Faced with this problem, one is tempted to have the corporation take some assets and then quickly file the election. However, an election once made is binding for that year and cannot be revoked even within the filing period.<sup>38</sup> Therefore, if upon solidifying the plans for the corporation, it becomes clear that subchapter S is not desired, there is no way to revoke the election. It might be suggested that the corporation could terminate the election simply by transferring stock to a new shareholder who refuses to consent to the election.<sup>39</sup> It is true that a new shareholder must consent to the election within 30 days or the subchapter S status terminates, and such termination is retroactive to the beginning of that taxable year. But where the transfer is expressly for the purpose of disqualifying the corporation, is the transferee a shareholder? A recent case makes it clear that the transaction must be a bonafide transaction and the new shareholder must be a true owner of the stock.<sup>40</sup> Therefore, this solution does not seem to be adequate for planning purposes. In connection with the requirement that all new stockholders must consent to the election, if the election is desired, a provision should be made between the shareholders that will restrain the sale of stock by any of them to a nonconsenting shareholder. Without that restriction, the requirement that all shareholders consent to a termination of the election can be easily circumvented.<sup>41</sup>

Whenever there is a real possibility that the corporation will experience losses in the early years, the subchapter S election is particularly valuable because the losses can be passed out and applied against the shareholder's income, at least to the extent of the shareholder's basis and his stock and debt.<sup>42</sup> This is particularly valuable where the corporation is forced to give up operations entirely. In the absence of a subchapter S election, the shareholder's first realization of any loss would occur at the time the securities were disposed of, and unless a valid 1244 election was made, such loss would be treated as a capital loss either under section 165(g) or under section

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<sup>37</sup> Regs. 1.1372-2(b).

<sup>38</sup> Regs. 1.1372-2(b)(3).

<sup>39</sup> Regs. 1.1372-4(b)(1).

<sup>40</sup> C. L. Hook. 58.26 P-HTC (1972); *see also* Regs. 1.1373-1(a)(2).

<sup>41</sup> Regs. 1.1372-4(b)(2).

<sup>42</sup> I.R.C. § 1374.

166(d). It was this strong desire for ordinary loss treatment that caused many lawyers to postpone incorporation and have the client continue the business as a sole proprietorship or partnership until there was some evidence of corporate success. Since 1958, as a result of the enactment of subchapter S and section 1244, it is not always necessary to defer incorporation until corporate success is assured.

Section 1244 was enacted specifically to put a small business corporation on a parity with an unincorporated business with respect to the characterization of losses resulting from a business failure by the corporation. Most appealing about section 1244 is that it carries no penalty for failure to qualify under the election. Section 1244 permits loss on the sale or exchange of common stock to be treated as an ordinary loss to the extent of \$25,000 – \$50,000 if a married couple files a joint return—if the stock meets the definition of 1244 stock.<sup>43</sup> Section 1244 stock is common stock issued by a “small domestic corporation” (meaning with respect to a new corporation, a capitalization of under \$500,000, but in making the calculation assets transferred to the corporation are valued at basis and debt is not considered) to an individual or partnership under a formal plan for the issue of only such stock and by an offering which is separate from other stock offerings.<sup>44</sup> In addition, at the time of the loss, the corporation must have a history dating back as far as five years, or formation, of not receiving more than 50 percent of its gross receipts from passive resources. 1244 permits corporate losses to be used by the shareholder only where he incurs a realization as a result of the sale of the stock. In this sense subchapter S is superior for purposes of passing through losses. However, 1244 is useful whether or not subchapter S is elected. Consider the situation where a high risk business is being conducted in subchapter S form because of the early losses that were anticipated. Now suppose the critical time has come when the corporation may strike it rich or go broke. If 1244 stock was originally issued, the shareholders, if they have a high income bracket, may elect to terminate the subchapter S election rather than risk the pot of gold being poured into their 79 percent tax bracket pockets. In the event the corporation misses its big chance, 1244 will still be available as a safety valve. Of course, the other obvious role for 1244 is in the situation where the corporation cannot qualify for the subchapter S election.

The impact of section 1244 is felt in making a decision concerning the capital structure of a corporation. The ordinary loss treatment is preferable to short term capital loss treatment accorded nonbusiness debt and, therefore, may favor switching from debt to common stock. This will probably not happen because debt has so many advantages over equity if the business does well. Interest deductions and tax free return of capital far outweigh any preference which is predicated entirely on the failure of the business. It

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<sup>43</sup>I.R.C. § 1244.

<sup>44</sup>Regs. 1.1244(c)-1(c).

should also be noted in this connection that 1244 ordinary loss treatment is only available to the shareholder to whom the stock was issued. Later, purchasers of the stock do not receive ordinary treatment for losses.

Although only common stock is eligible for ordinary loss treatment, there is no one class stock requirement under 1244 as there is with respect to subchapter S. A corporation may have 1244 stock plus preferred stock. However, the requirement that the common stock be issued under a separate offering may impose a de facto one-stock requirement on the initial transfer of assets to a new corporation, unless one is willing to engage in an unbelievable amount of maneuvering in order to finesse through the hyper-technical rules dealing with the offering, issue, and plan. These rules provide that no part of any prior offering may be outstanding at the time the plan is adopted. Also, if any subsequent offering is made, any stock issued under the prior offering, but after the subsequent offering was adopted, will be disqualified.<sup>45</sup> Stock issued under the prior offering before the subsequent offering was made remains 1244 stock. Take, for example, the situation where a going concern is incorporated, and it is desired to give a combination of preferred and common stock for the business assets. How can the transactions be separated into separate offerings, one for common and one for preferred, and the offerings timed in such a way that one would not be outstanding when the other was made? The answer may be that there is no harm in trying since 1244 carries no penalty if qualification under the election cannot be achieved. But if section 1244 treatment is to be guaranteed for the common stock, the preferred stock would have to be eliminated. It must also be noted that any stock issued for ineligible consideration such as services or securities will be considered issued under a subsequent offering and all stock issued thereafter will be ineligible for the 1244 treatment.<sup>46</sup> In considering subchapter S, Professor Herwitz's example of the incorporation by a sole proprietor who was incorporating as a part of a plan to bring in an employee with no money and an investor not interested in working in the business was introduced. In that situation, in order to accomplish the desired control and to avoid serious problems concerning the issuance of stock for future services, only a very small amount of common stock was issued. Section 1244 is not very useful in that situation. One must reach the conclusion that the 1958 legislation designed to aid small business enterprises, namely subchapter S corporations and section 1244, at least in its present form, is not readily available in the situation where stock is to be issued to some for service and others for money or business assets, a situation that commonly occurs in small business enterprises.

### MULTIPLE CORPORATIONS

There is a great temptation to say simply that, as a result of the 1969 Reform Act, decisions to form multiple corporations can no longer be tax

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<sup>45</sup> Regs. 1.1244(c)-1(b).

<sup>46</sup> Regs. 1.1244(c)-1(h).

motivated. That temptation must be resisted because there are still some tax advantages to consider in making the decision to form multiple corporations. These are just a few:

1. partial utilization of subchapter S,
2. the use of separate accounting methods or taxable years, and
3. where eventual sale or distribution of certain assets are contemplated, the problem of 346 collapsible corporations and 337 sales can be dealt with easier where multiple corporations are used.

However, the multiple surtax exemption and the multiple accumulated earnings credit, which were the primary motivators for forming multiple corporations, are no longer available after 1974 unless the corporation can avoid a classification as a controlled group under section 1563.<sup>47</sup> The result of the 1969 act is a phase-out of section 1561, which permitted the election of multiple surtax exemptions at the cost of a six percent penalty, and the de facto elimination of section 1551 which depended on tax motivation.

A controlled group is either one or more parent subchains of corporations connected with a common parent corporation through 80 percent or more in stock ownership (voting or value) or a brother-sister controlled group consisting of two or more corporations owned by five or fewer who are individuals, estates, or trusts owning 80 percent by vote or value of each corporation with 50 percent pro rata ownership in each. One way of avoiding the brother-sister controlled group classification is to issue each of the parties a different proportionate ownership in each corporation since, under section 1563, the common owners must own more than 50 percent of each affiliate corporation, and in making that calculation, only identical ownership by each member of each corporation is counted. That means that if X corporation shares are held 90 percent by A and 10 percent by B and Y corporation shares are held 90 percent by B and 10 percent by A, the test is not met because under the identical ownership requirement, only 20 percent of the ownership in X and Y is assigned to A and B. There are attribution rules which are rigorously applied, but leave some slight room for maneuvering.<sup>48</sup> For instance, family relationships except for a parent and a minor child are ignored, except for stockholders who own more than 50 percent of the control or value of the corporate shares.<sup>49</sup> Attribution from a spouse is ignored if the other spouse has no actual ownership in the corporation. Also, subsidiary controlled group treatment can be avoided by restricting the parent to 79 percent ownership.<sup>50</sup>

Although avoiding controlled group treatment will prevent automatic denial of multiple surtax exemptions and accumulated earnings tax credits, it does not assure that either will be available. Section 269 can still be used by the Commissioner where there is 50 percent common control by

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<sup>47</sup>I.R.C. § 1563(a)(2).

<sup>48</sup>I.R.C. § 1563(c).

<sup>49</sup>I.R.C. § 1563(c)(6).

<sup>50</sup>I.R.C. § 1563(a)(1).

one or more owners (determined without the identical ownership requirement in section 1563) where the principal purpose in acquiring such control was the evasion or avoidance of federal income tax. Section 482 is also available to the Commissioner for the purposes of making adjustments between related enterprises.

Although section 482 requires two or more organizations to be owned or controlled by the same interest before adjustments between them can be made, the ownership or control requirement is much more amorphous than it is with respect to section 269 or section 1551. Any kind of de facto control or ownership will suffice to bring this section into play.<sup>51</sup> It is commonly said that section 482 is confined to the reallocation of income and deductions rather than to the creation of income or denial of deductions. By and large, that statement is true, but it is obvious that the section would be drastically curtailed if the courts adopted it literally. In other words, it is clear that the Commissioner can make adjustments to a non-arm's length transaction so long as the net effect between the two corporations does not create income or deny a deduction. Take, for example, an interest-free loan made by one related corporation or organization to another. There does not seem to be any doubt that the Commissioner can compute an interest factor, which will result in income to the lender provided an offsetting interest deduction is given to the borrower. Section 482 should not be used as a type of enforced consolidated return which results in treating all the enterprises as one. Although consolidated returns cannot be discussed in detail where multiple corporations are formed in a chain of parent subsidiary corporations, the filing of a consolidated return is an option which must be considered.<sup>52</sup> It should be noted that a consolidated return cannot be filed by brother-sister affiliated corporations.

### TAX ACCOUNTING

The initial decisions as to which accounting methods and procedures the new corporation will elect to employ should be influenced by careful balancing of many competing factors, only some of which are pure tax considerations. One of the most crucial ingredients in this balancing process is the relatively sophisticated attempt to forecast profit, business needs, and the overall business position of the corporation that will exist five, 10 or 20 years into the future. Certain businesses may have large expenses in early years, so it may be desirable to use an accounting method that allows the corporation to recognize as much income as possible in those years, having in mind the loss carried forward is only available for five years. The accrual method seems the most obvious choice on these facts. On the other hand, initial expenses may be small, indicating that it may be desirable to defer income to later years. In this situation, the selection of the cash method of accounting or the selection of the fiscal year that ends before receipt of the large amount of seasonal

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<sup>51</sup>Spicer Theatre, Inc. v. Comm'r., 346 F.2d 705 (6th Cir. 1965).

<sup>52</sup>I.R.C. § 1501.

income seems to be a suitable solution. The selection of such a fiscal year will have the effect of a permanent tax deferment in that there will always be some deferred income so long as the corporation continually grows. The initial decision in selecting the method of accounting is crucial because the method, once selected, cannot be altered, except with the permission of the Commissioner.<sup>53</sup>

There are very real distinctions between tax accounting and generally accepted business accounting principles. Under the latter, the primary consideration is the proper matching of revenues and expenses during the corporation's annual accounting period. On the other hand, tax accounting is grounded on the theory that the tax should be paid when the money is available and the concept of annual accounting is more rigidly followed. Essentially, this means that for tax accounting purposes, even under the accrual method, if payments are received for future services or goods, those amounts, unless restricted as to use, are to be included in income.<sup>54</sup> A special procedure under Rev. Proc. 70-21 has been established to permit the taxpayer to elect to defer prepayments.<sup>55</sup> Generally, deferral for the payments of future services cannot extend beyond the end of the year following the year of receipt and then only if the services are to be performed before the end of that year. On the other hand, advance payments for the sale of goods can generally be deferred until the time at which they normally would be accounted for. (Apparently, the distinction between the sale of goods and the sale of services is due to a deference to gross income. Receipts from the sale of goods do not constitute gross income until after the deduction for the cost of goods sold.)

## DEPRECIATION

The intricacies of depreciation are too detailed to permit inclusion. It may be noted that if the subject property is acquired from the individual proprietor or from a partnership, the depreciation methods available to the corporation are limited to straight-line.<sup>56</sup> This results from the original use requirements necessary to qualify for the election of accelerated depreciation. This debilitating aspect must be considered in making the decision to transfer property to a corporation or to work out a rental arrangement with the shareholders, at least until straight-line depreciation catches up with an accelerated method presently in use by the shareholders. This depreciation factor alone may cause the incorporation to be postponed.

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<sup>53</sup>I.R.C. § 446(e).

<sup>54</sup>See Llewellyn, *Prepaid Income: Can a Deduction Be Taken for Reserve for Related Expenses?* 30 J Taxation 330 (1969).

<sup>55</sup>Rev. Proc. 70-21 I.R.B. 1970-35.

<sup>56</sup>Regs. 1;167(c)-1(a)(6).