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Journal

National Black Law Journal, 4(1)

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Publication Date

1975

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THE FEDERAL INCOME TAX IMPACT OF THE OPERATING FUNCTION ON THE CHOICE OF BUSINESS FORM: PARTNERSHIP, SUBCHAPTER C CORPORATION, OR SUBCHAPTER S CORPORATION

Samuel C. Thompson, Jr.*

INTRODUCTION	12
I. TAXATION OF PARTNERSHIPS AND PARTNERS	14
1. <i>A Note on General and Limited Partnerships</i>	14
2. <i>The General Scheme</i>	16
3. <i>Limitations on Loss Deductions</i>	20
4. <i>The Effect of Partnership Liabilities on the Partner's Loss Deductions</i>	21
5. <i>Current Cash and Property Distributions by Partnerships</i>	24
6. <i>Guaranteed Payments of Partnerships</i>	26
II. TAXATION OF SUBCHAPTER C. CORPORATIONS AND SHAREHOLDERS	29
1. <i>The General Scheme</i>	29
2. <i>The Accumulated Earnings Tax and The Personal Holding Company Tax</i>	31
3. <i>Current Distributions of Cash and Property by Subchapter C Corporation</i>	34
4. <i>Mitigation of the Double Tax</i>	37
III. TAXATION OF SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS	43
1. <i>The General Scheme</i>	43
2. <i>Current Cash and Property Distributions by Subchapter S Corporations</i>	50
IV. COMPARATIVE ANALYSIS OF THE FORMS	55
1. <i>The Partnership Form</i>	56
2. <i>The Subchapter C Form</i>	56
3. <i>The Subchapter S Form</i>	57
4. <i>Comparative Analysis</i>	57

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*"Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that [form] which will best pay the treasury; there is not even a patriotic duty to increase one's taxes."**

INTRODUCTION

The federal income tax impact of the operating function¹ of a business enterprise may vary depending on the business form. Of course, other functions such as organizations, liquidations, reorganizations, redemptions of ownership interests, sales of ownership interests, deferred compensation arrangements,² etc., may also have a tax impact on the choice of form, but

** Judge Learned Hand's immortal words in *Helvering v. Gregory* 69 F.2d 809, 810 (2nd Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

1. The term operating function is used here to mean the normal revenue generating functions of the business enterprise and current cash and property distributions to owners. In addition, corporate nonliquidating redemptions of stock and securities are discussed briefly.

Because of the breadth of this topic a detailed discussion of the penumbra of combinations and permutations of problems which may arise with respect to anyone of the areas discussed is beyond the scope of this article. Consequently, the discussion may seem truncated in places; however, an attempt has been made to cite the reader to more detailed authorities in each area.

The leading treatise on the federal income taxation of partnerships is A. WILLIS, *WILLIS ON PARTNERSHIP TAXATION* (1971) [hereinafter "WILLIS"], and the leading treatise on corporations and shareholders, including Subchapter S corporations, is BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1971) (Supp. 1973) [hereinafter "BITTKER & EUSTICE"].

To the author's knowledge this is the only article treating exclusively the operation function of the three forms. For other works treating various areas see Axelrad, *Choice of Form: Partnership, Corporation; Or in Between*, 19th N.Y.U. ANN. INST. OF FED. TAX 361 (1961); Dixon, Barnett, Evall, Geller, Kalish, *Partnerships and Subchapter S: A Comparison of Tax Advantages*, 25th N.Y.U. ANN. TAX INST. ON FED. TAX 151 (1967); Grant, Alder, Kaufman, Lees, *The Relative Tax Advantages of Partnerships and Subchapter S Corporations*, 21st SOUTH CAL. LAW CENTER TAX INST. 409 (1969); and Kalish, *Partnerships, Subchapter S and Non-Special-Status Corporations*, 28th N.Y.U. ANN. INST. ON FED. TAX 509 (1970).

2. This article is not concerned with organizations, liquidations, reorganizations, redemptions of ownership interest, sales of ownership interests, deferred compensation arrangements, etc., each of which would lend itself to a separate article.

There are several federal income tax fringe benefits which can be of crucial importance in the determination of choice of form. In general these fringe benefits are available only to employees. Since a shareholder can be an employee of his corporation, shareholder-employees qualify for such fringe benefits. A partner cannot, in general, be an employee of his partnership, and, therefore, will not qualify for such fringe benefits. Consequently, other things being equal, the corporate form may be chosen in order to secure certain fringe benefits for shareholder-employees.

Some of these fringe benefits are as follows: An employee excludes from his gross income the premiums paid by his employer for group term life insurance up to a principal amount of \$50,000, INT. REV. CODE OF 1954, §79 [hereinafter sometimes referred to as the "CODE"; all citations are to the CODE]. The beneficiary or estate of a deceased employee excludes from gross income an amount up to \$5,000 paid by or on behalf of the employer by reason of the death of the employee, section 101(b). An employee excludes from gross income contributions by his employer to accident and health plans for compensation for personal injuries or sickness, section 106. Employees may in certain cases exclude from gross income wage payments up to a maximum of \$100 per week paid while the employee is absent from work because of personal injuries or sickness, section 105(d). In certain cases an employee can exclude from gross income the fair market value of meals or lodging provided by the employer, section 119. *But see*, *Armstrong v. Phiney*, 394 F.2d 661 (5th Cir. 1968) (holding that a partner can be an employee for purposes of section 119). Most importantly an employee may not have to include in gross income an employer's contributions to deferred compensation arrangements which are designed to provide retirement benefits. Further, the income earned by such contributions may be exempt from taxation, thereby increasing the amount of the funds available for retirement distributions. The employee is taxed on the distributions when made. However, at such time he is likely to be in a lower tax bracket than at the time of contributions

these functions are not, in most cases, as important to such decision as the operating function.

The tax impact of the choice of form may be determinative of the success or failure of the business enterprise. The choice of Form A might lead to an effective rate of taxation of 25%, whereas Form B might provide a 70% rate. In such case, the tax savings to be derived from the choice of Form A would be \$45 of every \$100 of taxable income. Although this is a somewhat exaggerated example in that it approaches the outer limits of the potential tax stakes involved in the choice form, nevertheless income taxes, like salaries, are part of the costs of operating the business enterprises, and if Form A will be less expensive tax wise than Form B, other things being equal, Form A should be chosen. The federal income tax impact, of course, will not be the only factor in the choice of form, but it is crucial in that it can operate directly on the economic viability of the business enterprise.

This article is a comparative analysis of the federal income tax impact of operating a business enterprise as (1) a partnership,³ (2) a Subchapter C corporation,⁴ or (3) a Subchapter S corporation.⁵ These three forms in addition to the sole proprietorship, are the basic tax forms for conducting business enterprise. Under the sole proprietorship form all income, deductions, credit, and loss of the business enterprise is attributed directly to the proprietor; the proprietor conducts the business activity and is the tax form. This can be distinguished from the other three in that a form is interposed between the business activity and the owners.⁶

The article will proceed with a discussion of the scheme the Internal Revenue Code of 1954 provides for taxing the operating function of each of the three forms, after which the tax impact which would be produced by the three in a particular fact situation will be comparatively analyzed. First, a general description of the three is appropriate.

Partnerships⁷ are not subject to the federal income tax. Each partner

thereby further reducing the tax cost of compensation, sections 401 et seq. See generally Leonard Murray's article in this Journal, *Deferred Compensation Arrangements for the Closely Held Corporation*. Self-employed individuals can also establish deferred compensation arrangements under the Keogh plan, but the exclusion from gross income for contributions is limited.

3. The taxation of partners and partnerships is governed by subchapter K of chapter 1 of the CODE, sections 701-771.

4. The term Subchapter C corporation is used here to mean a corporation which is subject to all the provisions of Subchapter C of chapter 1 of the CODE, sections 301-393. The CODE provides special tax treatment for various other types of corporations. See generally BITTKER and EUSTICE 1-21 to 24.

5. The term Subchapter S corporation is used here to mean a corporation which has made a valid election to be taxed pursuant to the provisions of Subchapter S of chapter 1 of the CODE, sections 1371 to 1379. A Subchapter S corporation is subject to the provisions of Subchapter C except where otherwise specifically provided in Subchapter S.

6. The three forms will hereinafter be referred to collectively as "the firms", the shareholders or partners will collectively be referred to as the "owners", and stock or partnership interest will be collectively referred to as "ownership interests."

7. For a discussion of the federal income tax meaning of partnership see text accompanying note 9, *supra*. The Uniform Partnership Act defines the term as follows:

A partnership is an association of two or more persons to carry on as co-owners a business for profit.

This definition is not controlling for tax purposes.

must include in his gross income his share of the partnership's taxable income whether such income is distributed or not. Correlatively, each partner will deduct from his gross income his share of the partnership's losses. Current property or cash distributions from partnerships do not, in general, generate income to the partners. Partnerships can be either general or limited. But, for the most part, the tax impact of the operating function will be the same for the two.

A Subchapter C corporation is a taxable entity separate and distinct from its shareholders. In general, such corporations are required to pay a federal income tax on their taxable income for each taxable year, and shareholders are subjected to a tax liability on receipt of a current distribution of cash or property from the corporation. Subchapter C corporations and their shareholders are, therefore, subjected to two taxes, whereas partnerships and partners are only subjected to one.

Subchapter S corporations are tax hybrids; they are, in effect, crosses between partnerships and corporations. With respect to the operating function of the business enterprise, however, the tax scheme for Subchapter S corporations is for the most part analogous to the tax scheme for partnerships; that is, the Subchapter S corporation is not, in general, subject to taxation and each shareholder is required to include in his gross income his proportionate share of the corporation's taxable income whether or not distributed and, correlatively, will deduct his proportionate share of the corporation's losses. The analogy to partnership taxation is not a complete one; the schemes differ to a great extent. For instance, current property distributions by Subchapter S corporations, with certain exceptions, will be treated similarly to such distributions by Subchapter C corporations, and Subchapter S corporations may be subject to taxation.

I. PARTNERSHIPS AND PARTNERS⁸

1. *A Note on General and Limited Partnerships*

At the outset, it is desirable to distinguish the two types of partnerships⁹ and further to distinguish in part and analogize in part the limited partnership¹⁰ and the corporation.¹¹

8. For a discussion of some proposed changes to the partnership provisions see Anderson and Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX L.R. 285 and 497 (1960).

9. The term "partnership" is defined in both sections 7701(a)(2) and 761(a), and the definitions are substantially the same. The section 7701(a)(2) definition is as follows:

The term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Both Treas. Reg. § 301.7701-3 (1960) and Treas. Reg. § 1.761-1 (1972) make it clear that the term is "broader" than the normal common law meaning of the term, but is not sufficiently broad to include "mere joint undertakings to share expenses . . ." or "[m]ere co-ownership of property . . .", such as by tenants in common. Treas. Reg. § 1.761-1(a) (1972).

10. Limited partnerships are described in Treas. Reg. § 1.7701-3(b) (1960). In essence the regulation says that limited partnerships under state law will be either classified for tax purposes as "ordinary partnerships" or "associations." If classified as an association they will be taxed as a corporation rather than a partnership. The term corporation is defined in section

In a general partnership all partners can have a say in management and are jointly and severally liable for the obligations of the partnership. In a limited partnership, a limited partner does not have a say in management and his liability is normally limited to the amount of his contribution. A limited partner is in an analogous position to a shareholder with respect to liability but not with respect to control.

There is no requirement that a partner be an individual;¹² a corporation could be a partner. Consequently, a limited partnership can be structured to provide the benefits of corporate control and limited liability while concomitantly retaining the partnership form for tax purposes. This can be done by having a corporation owned by individual limited partners be the general partner in a limited partnership. The limited partners would have complete control over the general partner, and thereby complete control over the management of the partnership. In addition, they would be shielded from the obligations of the corporation by reason of their shareholder status and shielded from the obligations of the partnership by reason of their limited partner status.

The Commissioner of Internal Revenue looks askance at such vehicles. In essence, his position is that if a limited partnership has the characteristics of a corporation, then it should be taxed like a corporation, thus providing, *inter alia*, for a tax on the income at the entity level and a second tax when the earnings are distributed to the investors. He has used his rule-making authority in an attempt to constrain the use of such vehicles. In

7701(a)(3) to include ". . . associations, joint stock companies, and insurance companies." The question of whether a limited partnership will be treated as an association is dependent on how many of the corporate characteristics the limited partnership has. Treas. Reg. § 301.7701-2(a) (1965) sets up six characteristics which are ordinarily found in a "pure corporation":

(a) *Characteristics of corporations.* (1) The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case.

The Regulation goes on to provide, *inter alia*, that in determining whether an organization is a partnership, or corporation, the organization will be considered a corporation if the "corporate characteristics are such that the organization more nearly resembles a corporation than a partnership . . ." *Id.* at 2(a)(1). In determining such resemblance the common characteristics between a corporation and partnership are disregarded and the determination is dependent on the uncommon characteristics. *Id.* at 2(a)(2).

A partnership in form can be a corporation for federal income tax purposes or a corporation in form can be a partnership. The Commissioner of Internal Revenue has attempted in the past to classify professional service corporations as partnerships for tax purposes. For a discussion of the problems of classifying organization for tax purposes see BITTKER and EUSTICE ch. 2; and WILLIS 3-13.

11. See discussion *supra* note 10.

12. Section 701 makes reference to the "persons" carrying on business as partners and section 7701(a) defines "person" as follows:

The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

Revenue Procedure 72-13¹³ he set out the standards which must be met before he will issue an advance ruling that a limited partnership with a corporation as general partner will be treated as a limited partnership for federal income tax purposes.¹⁴

2. The General Scheme

Section 701 provides that partnerships, "shall not be subject to the [federal] income tax . . ." and that the "[p]ersons carrying on business as partners shall be liable . . ." for such tax. A partnership is a mere conduit through which "income, gain, loss, deduction or credit . . ."¹⁵ generated by the partnership's business activity are passed on to the partners. The income items have the same character (e.g. capital gains or ordinary income) to the partners as they do to the partnership,¹⁶ and are separated into nine

13. 1972-1 C.B. 735.

14. Revenue Procedure 72-13 sets up the following six standards:

(1) The limited partners, members of their families and certain affiliated business entities cannot own more than 20% of the corporation. This is designed to prevent the limited partners from controlling the corporate general partner and thereby controlling the management of the partnership.

(2) In cases where the total contributions to the limited partnership is less than \$2.5 million, the net worth of the corporate general partner, exclusive of its partnership interest, must be the lesser of 15% of the total contributions or \$250,000. If the contributions exceed \$2.5 million the net worth of the corporate general partner must be 10% of the contributions. This net worth requirement is designed to ensure that the general partner has substantial assets which are subject to partnership obligations. This requirement seems to be related to an example in the regulations which holds an organization to be a limited partnership because *inter alia*:

The three general partners are *personally capable* of assuming a substantial part of the obligations to be incurred by the organization. (emphasis added)

Treas. Reg. § 301.7701-3(b)(2) (example 1) (1960)

If the corporate general partner is without substantial assets it would not be able to assume "a substantial part of the obligations" of the partnership.

(3) If the corporate general partner is a member of more than one limited partnership then the rules concerning net worth apply separately to each.

(4) The current fair market value of the corporation's assets is used in calculating the net worth of the corporation.

(5) The purchase of a limited partnership interest will not also give the limited partner an interest in the stock or an option to buy the stock of the corporate general partner.

(6) The limited partnership must be operated in accordance with state law.

See also, Rev. Proc. 74-17 1974-22 I.R.B. 7, June 3, 1974, where the service set out certain additional conditions which must be met before it will issue a revenue ruling concerning the classification of an organization as a limited partnership where there are factual questions of whether the principal purpose of the organization is the reduction of federal taxes. In such cases there are three basic operating rules which must be met before the service will rule that an organization is a limited partnership. First, the general partnership interest of all general partners, taken together, in each item of partnership income, gain, loss, deduction or credit must be at least 1% of each such item at all times. Second, the aggregate loss deductions claimed by the partners for the first two years of the limited partnership must not exceed the amount of equity capital invested in the limited partnership. Third, a non-recourse creditor must not acquire, by reason of the loan, any interest in the profits, capital or property of the limited partnership, other than as a secured creditor.

15. INT. REV. CODE of 1954, § 704(a). The "income, gain, loss, deduction or credit" (hereinafter the "income items") are the classes of items resulting from transactions which a partnership engages in that produce an impact on the calculation of the federal income tax liability of the partners. For instance, a partnership's income includes total sales less cost of goods sold, Treas. Reg. § 1.61-(3)(a) (1973); gain includes capital gains from the sale of capital assets, Treas. Reg. § 1.61-6 (1957); loss includes the net operating loss, section 172; deduction includes the depreciation deduction, section 167; and credit includes the investment credit, section 38.

16. INT. REV. CODE of 1954, § 702(b). Section 702(b) provides that the character of income items in the hands of a partner shall be determined as though the partner had realized

classes which are organized so as to insure the integrity of the character of the items in the hands of the partner.¹⁷

An individual partner's share of partnership ordinary income will be included in his gross income and thereby subjected to taxation under section 1 which provides for tax rates between 14% and 70% depending on the individual's status and tax bracket. Consequently, the maximum tax on an individual partner's distributive share of a partnership's ordinary income is 70%. Moreover, since the character of the items passes through, there is a measure of flexibility in an individual partner's share of long term capital gains which will be subject to preferred rates which can vary from 7% to 35% depending on the individual's status and tax bracket.¹⁸

A partner's share of each class of income item is known as his "distributive share" which, in general, is determined in accordance with the partnership agreement.¹⁹ It is not necessary that a partner's distributive share be the same for each class of income item. A partner's distributive share

the item "directly from the source from which realized by the partnership . . ." Section 702(b) treats the partnership as an aggregate rather than an entity. For some purposes a partnership is an entity, *see generally* note 17 (second paragraph), *infra*

17. The nine classes are set out in paragraphs (1) through (9) of section 702(a), they are: (1) short term capital gains and losses, section 1222; (2) long term capital gains and losses, section 1222; (3) section 1231 gains and losses, section 1231; (4) charitable contributions, section 170; (5) dividends which qualify for the \$100 exclusion, section 116; (6) foreign taxes, section 901, (7) partially tax-exempt interest, sections 25 and 242, (8) the special items set out in Treas. Reg. § 1.702-1(a)(8) which are not included in any of the above seven categories and which are not ordinary income or loss items; and (9) the taxable income or loss exclusive of items (1) thru (8). *See* Treas. Reg. 1.702-1(a) (1972). *See generally*, WILLIS 41-49.

Section 703(a) requires that the ninth item, taxable income or loss, be computed in the same manner as if the partnership were an individual except that the items in paragraphs (1) thru (8) of 702(a) are separately accounted for and no deduction is allowed to the partnership for certain items such as the standard deduction, section 141, and the net operating loss deduction, section 172. Further, section 703(a) provides, in general, that any elections "affecting the computation of taxable income derived from a partnership shall be made by the partnership . . ." For the purposes of 703 a partnership is treated as an entity as opposed to an aggregate, *see generally* note 16, *supra*.

18. Section 1201(b) provides in essence that in the case of an individual the tax on the excess of net long term capital gains over net short term capital losses will be the lesser of (1) the tax imposed on such gains by section 1, or (2) 25% of the first \$50,000 of such gains plus from 25% to 35% of such gains in excess of \$50,000. Capital gains in excess of a certain level will be subjected to the section 56 penalty tax on tax preferences.

19. Section 704(a) reads as follows:

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement. The term "partnership agreement" is defined in section 761(c). It can be either oral or written, Treas. Reg. § 1.761-1(c) (1972), and includes all modifications agreed to by all of the partners or adopted in accordance with the provisions of the agreement prior to the time for filing the partnership return. As a practical matter a partnership agreement should be reduced to writing. This is particularly important because the federal income tax impact may be dependent on specific provisions of the partnership agreement, in the absence of which a general rule will apply. *See generally* WILLIS 25-26.

Two exceptions to the general rule that a partner's share is determined in accordance with the partnership agreement are set out in section 704(b): First, in the event the partnership agreement does not provide for the determination of a partner's distributive share of a particular income item, such determination shall be made in accordance with the partner's distributive share of the partnership's taxable income. Second, if the principal purpose of a provision in the partnership agreement allocating an income item is the "avoidance or evasion" of any federal income tax then a partner's distributive share of such item shall be determined in accordance with the partner's distributive share of taxable income.

of taxable income may be different from his distributive share of loss. For example, if the AB 50-50 partnership is formed with A and B agreeing to provide equal services but with B providing all of the capital, the partnership agreement may provide that A and B will each have a 50% interest in profits and B will have a 100% interest in partnership losses. In such a case, the profit sharing ratio would reflect the equal contributions of services and the loss sharing ratio would reflect the unequal contribution of capital. There is a measure of flexibility in determining the allocation of specific income items. However, an allocation which has tax avoidance as its principal purpose will not be given effect.²⁰

The operating losses which a partner is allowed to deduct are treated as losses from the operation of a trade or business and thus qualify for the section 172 net operating loss carryback and carryover,²¹ under which a loss in the current year can be used to reduce income in the three preceding and five succeeding years until the loss is exhausted. Similarly, the capital losses of a partnership are subject to the capital loss carryover provisions applicable to the partner.²² The tax-exempt income of a partnership is also tax-exempt income to the partners.

The federal income tax impact on a partner is based on the realization of income or the incurrence of loss by the partnership, not the partner's receipt of income from the partnership nor his actual incurrence of a loss.

Although a partnership is not a taxable entity it has a tax year²³ and must file an information return²⁴ for purposes of reporting its partners' distributive shares of its income items. There is no requirement that a partnership and its partners have the same tax years; there are, however, restrictions designed to minimize such disparities.²⁵ Basically, the restrictions have the effect of putting a partnership and each of its partners with interest equal to or greater than 5% of profits or capital on the same tax year.

The tax year in which the partner is required to account for his partnership's income items is the tax year in which or with which the partnership's tax year ends. For instance, if the partnership's tax year is coterminous with the partner's tax year, the partnership's income items reported by the partner for his tax year will be the items the partnership realized during his tax year. Whenever the tax years are not coterminous, some portion of the income items the partner is required to report will have been realized by the partnership during the partner's preceding tax year, and the partner will re-

20. INT. REV. CODE of 1954, § 704(b)(2). For a detailed discussion of special allocations see WILLIS 201-22.

21. Treas. Reg. § 1.702-2 (1956) provides, *inter alia*:

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of [operating loss] of the partnership.

22. In the case of an individual section 1212(b) provides, in general, that capital losses in excess of gains can be carried forward to an unlimited number of future tax years until exhausted.

23. INT. REV. CODE of 1954, § 706(b).

24. Treas. Reg. § 1.701-1(a), and INT. REV. CODE of 1954, § 6031.

25. Section 706(b)(1) provides, *inter alia*:

A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary or his delegate, a business purpose therefore.

port for his succeeding tax year the portion of the income items realized by the partnership between the close of its tax year and the close of the partner's. The most exaggerated disparity would occur in a case where the partnership's tax year ended on January 31 and the partner's on December 31. In such case, the partner would report for his current tax year the partnership income items which were realized during the period from February 1 of the preceding tax year to January 31 of the current tax year.

The requirement that a partner account for his distributive share of partnership income items, without regard to whether there is a distribution by the partnership, makes it necessary that the partner's investment in the partnership be adjusted to reflect such accounting. A partner's partnership investment for tax purposes is represented by the adjusted basis in his partnership interest.²⁶ In general, a partner's adjusted basis is increased by the amount of his distributive share of the taxable income of the partnership and decreased by his distributive share of the partnership's losses.²⁷ If the partnership has income on which its partners are taxed but such income is not distributed to the partners, each partner's investment in the partnership has increased. The transaction can be viewed as though the partner had actually received the income on which he is taxed and then contributed such income to the partnership. Such a contribution would generate an increase in the adjusted basis of the partner's partnership interest under section 722. Correlatively, if a partnership incurs losses which its partners deduct in computing their taxable incomes, each partner's tax investment in the partnership has decreased. It is analogous to a depreciation deduction on a building which generates a correlative reduction in the adjusted basis of the building. The deduction is a return of the partner's capital, and in order to reflect such return, it is necessary to reduce the adjusted basis of the partner's partnership interest. In the absence of such basis adjustments, double taxation of income or double deduction of loss could arise.²⁸

26. A partner's initial adjusted basis is determined, for instance, under (1) section 722 if the partner makes a contribution to the partnership in exchange for a partnership interest, or (2) section 742 if the partner purchased his partnership interest from a selling partner, or (3) section 1014 if the partner inherited the partnership interest, or (4) section 1015 if the partner received the partnership interest by gift.

27. Section 705(a)(1)(A) requires that the partner increase the adjusted basis of his partnership interest by the amount of the taxable income of the partnership.

Section 705(a)(2)(B) requires that the partner decrease the adjusted basis of his partnership interest by the amount of his share of the partnership's losses which are deductible. For a discussion of the deductibility of partnership losses see text accompanying notes 43-46, *infra*.

28. Double taxation would attach if a partner was taxed on his distributive share of partnership income which stayed in the partnership but was not permitted to increase the adjusted basis of his partnership interest. In such case he would be taxed once when the partnership earned the income and again if he sold his partnership interest. INT. REV. CODE of 1954, § 741. For example, if a partner's initial adjusted basis and fair market value for his partnership interest was \$10K and his distributive share of partnership taxable income was \$5K all of which he included in gross income and none of which was distributed, then, other things being equal, the value of his partnership interest would be \$15K and if he sold his interest without an increase in his adjusted basis he would have a second \$5K inclusion in gross income pursuant to section 741. Correlatively if the partnership had a loss rather than gain and the partner's distributive share of such loss was \$5K all of which he deducted, then, other things being equal, the value of his partnership interest would be \$5K and if he sold his interest without a reduction in his adjusted basis he would have a second loss deduction of \$5K under section 741. The second gain or loss would, in general, be capital.

The adjusted basis on a partner's partnership interest is also increased by the tax-exempt income earned by the partnership; otherwise there could be an indirect tax on such income.²⁹ Reductions are required for expenditures of the partnership which are neither deductible nor capitalizable.³⁰ An example of such an expenditure is insurance premiums paid for life insurance on the lives of key partners. Since the proceeds of life insurance are not included in gross income,³¹ the Code provides that premiums are not deductible.³² In the case of term insurance none of the premium is capitalizable, therefore the full amount of the premium would operate to reduce the adjusted basis of the partners' partnership interests. In the case of a whole life policy, however, the portion of such premiums which is attributable to an increase in cash value of the policy would appear to be capitalizable and, therefore, would not generate a basis reduction.

In addition to the above rules with respect to determination of basis, a partner has the option of determining his basis, in accordance with the regulations, "by reference to his proportionate share of partnership property upon the termination of the partnership."³³

3. *Limitations on Loss Deductions*

The pass through of partnership losses can be of particular advantage since a partner can use such losses to offset his other income. As noted above, the pass through of a loss will generate a reduction in the adjusted basis of the partner's partnership interest, because the loss deduction represents a return of the partner's capital. What happens, however, when the partnership has losses, but the adjusted basis of a partner's partnership interest is zero?

In such case the partner has had a return of all his capital and theoretically any additional loss deduction would represent a windfall to the extent it produces a tax savings. For example, if the AB 50-50 partnership is formed and A contributes property with a fair market value of \$100K (As used hereinafter, "K" represents \$1,000) which has a basis of zero, the basis of his partnership interest would be zero pursuant to section 722. Assume that the reason for the zero basis was that the property had been fully depreciated and A had thereby fully recovered his capital invested in the property. If the partnership operated at a loss and A was able to deduct his distributive share of such loss he would be in receipt of a windfall to the extent of the tax savings because he had already recouped his capital through the depreciation deduction. The same principle applies to all cases when the basis of the partnership interest is zero, without regard to the cause of such zero basis. Such windfalls are prevented, however, by section 704(d)

29. INT. REV. CODE of 1954, § 705(a)(1)(B). Tax-exempt income includes interest on municipal bonds which is exempt under section 103(a).

The indirect tax on tax-exempt income, in the absence of a basis increase in respect of such income, would occur because the fair market value of the partnership would increase by reason of the receipt of such income. The basis increase is necessary to prevent a tax on such increased value at the time of sale of a partnership interest.

30. INT. REV. CODE of 1954, § 705(a)(2)(B).

31. INT. REV. CODE of 1954, § 101(a).

32. INT. REV. CODE of 1954, § 264(a)(1).

33. INT. REV. CODE of 1954, § 705(b).

which limits a partner's deduction for his distributive share of partnership losses to the adjusted basis of his partnership interest. Section 704(d) reads as follows:

A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

In a case where losses exceed the adjusted basis of the partnership interest, the partner's distributive share of such losses are carried over to succeeding tax years until the partner's adjusted basis is increased.³⁴ Such non-deductible losses are, in essence, held in a suspense account and carried over to future tax years. This gives the partner a certain degree of flexibility in determining when to cause the losses to be passed through in succeeding years. The fact that the losses will be placed in a suspense account until there is sufficient basis will not affect the net operating loss carryback and carryover which is determined at the partner level.³⁵ If a partner's share of loss in year one is not deductible because he has a zero basis for his partnership interest, and the loss is not passed through until year ten, the loss will then qualify to be carried back for three years and forward for five years.

Although neither the statute, regulations, legislative history, and cases do not address the question, apparently a suspense account loss is personal to the partner to whom the loss was initially attributable, so that the suspense account will vanish on the disposition of the partner's partnership interest.³⁶

There is no statutory provision preventing a partner from making an additional investment in his partnership just before the close of its tax year in order to increase the adjusted basis in his partnership interest, thereby increasing the amount of the deductible loss. However, such an investment would be vulnerable if it were not bona fide.

4. *The Effect of Partnership Liabilities on the Partners' Loss Deductions*

The amount and character of liabilities which a partnership has, can be of substantial importance in determining the amount of partnership losses which will pass through to the partners as opposed to going into a suspense account.

In order to comprehend the rationale for the treatment of partnership liabilities it is helpful to understand the holdings in two landmark cases. *Parker v. Delaney*³⁷ teaches that both recourse liabilities (personal) as well as nonrecourse liabilities (nonpersonal) assumed in the acquisition of property become a part of the purchaser's cost basis³⁸ of such property. *Crane*

34. An increase in basis could occur, for instance, on a contribution of property to the partnership, section 722, or the earning of taxable income, section 705(a)(1)(A).

35. INT. REV. CODE OF 1954, § 172.

36. See WILLIS, at 191-92.

37. 186 F.2d 455 (1st Cir. 1950), cert. denied, 341 U.S. 926 (1951).

38. Section 1012 provides that "[t]he basis of property shall be the cost of such property, except as otherwise provided . . ."

*v. Commissioner*³⁹ teaches, *inter alia*, that the release of a liability, either recourse or nonrecourse, on the disposition of property is part of the amount realized⁴⁰ of the party disposing of the property. The following example will illustrate these principles. Assume that A owns an apartment building which has a fair market value of \$100K and an adjusted basis of \$50K, which is subject to a nonrecourse mortgage of \$75K. If B buys the building subject to the mortgage he will, (other things being equal), pay A \$25K which is the amount of equity in the building. Query: What is A's amount realized on the sale and B's cost basis for the building? *Parker v. Delaney* teaches that B's cost of the property includes not only the \$25K in cash but also the liability to which the property is subject, albeit B is not personally obligated on such liability. Therefore, B's basis for the property would be \$100K. *Crane* teaches that A's amount realized is not only the \$25K in cash but also the \$75K mortgage which goes with the property. A has a total amount realized of \$100K and since his adjusted basis for the property is \$50K he has a \$50K gain, albeit he only received \$25K in cash. Keeping these principles in mind, what happens to the adjusted basis of a partner's partnership interest when a partnership incurs a liability?

Taking a recourse borrowing by a general partnership, it is obvious that each partner's potential obligation has increased. That is, each partner will be liable if the partnership defaults on the loan. It is almost as though each partner personally borrowed his pro rata share of the money and then made a contribution to the partnership, in which case the basis of his partnership interest would increase.⁴¹

Section 752(a) treats this increased potential investment as a pro rata contribution of capital by the partners. Section 752(a) reads in part as follows:

Any increase in a partner's share of the liabilities of a partnership . . . shall be considered as a contribution of money by such partner to the partnership.

As a deemed contribution of money, there is an increase in the adjusted basis of the partner's partnership interest under section 722.

The *Parker* and *Crane* rationales have vitality in the partnership area.⁴² If a general partnership acquires property subject to a non-recourse liability, such liability is not only included in the partnership's basis of such property, but is also, pursuant to section 752(a), treated as a deemed contribution of money by the partners, thereby increasing the adjusted basis of their partnership interests. Consequently, borrowing by a general partnership may operate to permit a partner, who otherwise would not be able to do so, to deduct his distributive share of partnership losses by reason of an increase in the adjusted basis of his partnership interest.

39. 331 U.S. 1 (1947).

40. Section 1001(b) defines the amount realized from the sale or other disposition of property as ". . . the sum of any money received plus the fair market value of the property (other than money) received." The *Crane* rationale is that the release of a liability, either recourse or non-recourse is "property (other than money) received."

41. INT. REV. CODE OF 1954, § 722.

42. Section 752(c) provides:

For purposes of this section a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

Notice that section 752(a) provides that the deemed contribution is in proportion to the partner's relative shares of the liability. What if the profit sharing ratio is different from the loss sharing ratio? How, then, would the deemed contribution be determined? Economics would seem to indicate that in the case of a recourse liability the deemed contribution would be shared in accordance with the loss sharing ratio since, if the partnership were to default on the loan, the partners would have to cover the loss in accordance with the loss sharing ratios. This is precisely what the regulations call for:

A partner's share of the partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement.⁴³

If the partnership were a limited partnership, would any portion of a recourse liability be allocated to the limited partners? A limited partner would not be obligated to make a contribution to the partnership in the event of a default on a recourse liability unless he had not made the total contributions which he was obligated to make. Consequently, it would appear that in the case of a recourse liability the adjusted basis of a limited partner would not increase. The regulations provide for this result:

A limited partner's share of the partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement.⁴⁴

What if the partnership is a general partnership and the liability is non-recourse? In the case of a nonrecourse financing, general partners cannot be held liable for the partnership's obligation. The partners will share the benefits generated by the liability (such as the profits from an apartment building which is purchased on a nonrecourse mortgage), but they will not be liable if the deal flops and the mortgagee forecloses. They are in a situation where they can profit from the incurrence of the liability, but they cannot lose. Economics would seem to require, therefore, that the partners' relative shares of the liability would be determined in accordance with the profit sharing ratios. This rule would seem to be also applicable to limited partnerships, since in a nonrecourse financing the liability of all partners, general and limited, is limited. The regulations provide for such a rule:

[W]here none of the partners have a personal liability with respect to a partnership liability, . . . then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.⁴⁵

A nonrecourse financing will, therefore, operate to increase the adjusted basis of the partnership interests of both general and limited partners and thereby permit a pass through of a greater percentage of partnership losses than might otherwise be allowable. This is one of the principal reasons limited partnerships are tax shelter vehicles. For instance, in the normal real estate limited partnership, a nonrecourse financing will be arranged and the amount of the mortgage will be included in both the partnership's adjusted

43. Treas. Reg. § 1.752-1(e) (1956).

44. *Id.*

45. *Id.*

basis of the property for depreciation purposes and the partners' adjusted bases of their partnership interest. In the early years of the deal there will be a substantial depreciation deduction which will generate a tax loss but a positive cash flow. That is, the rents will be more than sufficient to pay the interest, real estate taxes, other expenses and to amortize the mortgage, so there will be excess cash available for distribution. However, the tax deductions, including depreciation, interest, real estate taxes and other expenses, will generate a tax loss. The partners are, therefore, in the situation of receiving a cash distribution while reporting a tax loss. Eventually the transaction will begin to produce taxable income in excess of the cash flow and on disposition there will be a paper gain, albeit such gain may be capital.⁴⁶

There is no statutory provision preventing a partnership from incurring liabilities just before the close of its tax year in order to increase the partners' adjusted bases for the purpose of increasing the amount of deductible losses. However, such a transaction might fail if it were not bona fide.

5. *Current Cash and Property Distributions by Partnerships*

Current distributions as used here refers to a partner's drawing of assets from the partnership which is not in either partial or complete liquidation of the partner's interest.⁴⁷ Such distributions are linked to the partner's distributive share of partnership profits. The partners will determine what percentage of the profits will be available for distribution and such amount will be transferred to the partner's drawing accounts in accordance with the profit sharing ratio.⁴⁸ Assuming a profitable partnership, the funds available for distribution will be the excess of the profits over the funds needed for expansion of the partnership business. The profits needed for expansion will be added to the partner's capital accounts in accordance with the profit sharing ratios. For example, in a 50-50 partnership if the total profits are \$100K and the partnership needs \$50K for expansion, \$25K would be transferred to each partner's drawing account and would be available for current distribution, and \$25K would be transferred to each partner's capital account.

Complete or partial liquidating distributions can raise a plethora of problems in the event the partnership has collapsible items which are unrealized receivables⁴⁹ or substantially appreciated inventory.⁵⁰ If a liq-

46. The above example is greatly oversimplified. For a detailed exposé and critique of the effect of the *Parker v. Delaney* and *Crane* rationales with respect to tax shelters see Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972). See also Adams, *Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966).

47. Treas. Reg. § 1.761-1(d) (1972) defines current distributions to include both distributions of the partner's distributive share and partial liquidations.

48. For a discussion of the capital and drawing account see WILLIS 27-29.

49. Unrealized receivables is defined in section 751(c) to mean, in general, payments to be received for goods sold and services rendered which the partnership has not yet reported as income. Accounts receivable of a cash basis taxpayer is a pure example of an unrealized receivable. The term is broader, however, than the name would indicate.

50. Substantially appreciated inventory is defined in section 751(d) to mean inventory which has a fair market value greater than (1) 120% of the adjusted basis of such inventory, and (2) 10% of the fair market value of all partnership property.

liquidating distribution of the collapsible items is not precisely proportionate to the partnership interest being liquidated, the distribution will be deemed, pursuant to section 751(b), to be a sale of the disproportionately distributed collapsible items between the partnership as constituted immediately after the liquidation, and the liquidated partner, and the gain attributable to the collapsible item will be ordinary income.⁵¹

A current distribution of cash will generate the following two consequences. First, pursuant to section 731(a)(1), there will be no gain to the distributee partner unless the amount of cash distributed is in excess of the adjusted basis for his partnership interest. Gain will be realized to the extent of such excess, and such gain will be a capital gain assuming that the partnership does not have any collapsible items. In addition, pursuant to section 733, the partner will reduce the basis of his partnership interest (but not below zero) by the amount of money distributed. This adjustment is a reflection of the fact that the partner has received a return of capital. For example, assume that in the AB 50-50 partnership, A's adjusted basis for his partnership interest is \$100K, and B's adjusted basis is \$10K. Further assume that each receives a current distribution of \$25K in cash. A would have no gain or loss pursuant to section 731(a)(1), and he would reduce the basis of his partnership interest from \$100K to \$75K pursuant to section 733(1). This would reflect the fact that the cash is a return of capital from the partnership. B would have a gain of \$15K pursuant to section 731(a)(1), because the cash distributed exceeds the adjusted basis of his partnership interest by \$15K. Such gain is a reflection of the fact that B has received a return of all the capital he had invested in the partnership plus an additional \$15K of cash. Such \$15K gain would be a capital gain, assuming the partnership did not have any collapsible items. The basis of B's partnership interest would be reduced to zero pursuant to section 733(1).

A current distribution of property other than cash will not generate gain to the distributee partner in any case.⁵² Further, the partnership will not have any gain or loss on the distribution of property with a disparate fair market value and adjusted basis.⁵³ There are two basis determinations which must be made as a result of a property distribution: First, the basis of the partner's partnership interest, and second, the basis of the property in the hands of the partner.

If the fair market value of property distributed is equal to the adjusted basis of such property, the property distribution is analogous to a cash dis-

51. A full discussion of such disproportionate distributions is beyond the scope of this article. The following is a very general description of the tax result. Section 751(b) creates sale treatment for such distributions, and as a result of such sale treatment the party (either the distributee partner or the partnership as constituted after the distribution) who ends up with more than his proportionate share of the collapsible items is deemed to have purchased such excess from the other party. Consequently, the other party will have ordinary income because he is deemed to have sold such excess. Moreover, the purchase and sale of such excess is deemed to have been made with other partnership property so that the purchaser may indeed have a gain attributable to the transfer of noncollapsible items in exchange for collapsible items. See generally WILLIS 391-416.

52. Section 731(a)(1) only provides for gain in the case of a distribution of cash in excess of the adjusted basis of the partnership interest.

53. INT. REV. CODE OF 1954, § 731(b).

tribution. This is so, because the basis of cash distributed is the amount of the cash, and the reduction in basis of the partnership interest generated by a cash distribution represents a mere shifting of basis in the partnership interest to the cash. This same result obtains in the case of a distribution of property which has a fair market value equal to its adjusted basis.⁵⁴

If the fair market value of the property distributed is not equal to the partnership's adjusted basis for such item, there is a potential gain or loss on the disposition of such property. Section 731(b) relieves the partnership from recognition of such gains or losses on distributions. Thus, in order to preserve the potential gain or loss, the partnership's basis for such item would have to carry over to the distributee partner. Also, a property distribution, like a cash distribution, represents a return of capital to the partner. There is, therefore, the double problem of (1) preserving the potential gain or loss on the partnership property distributed, and (2) treating the distribution as a return of the partner's capital. The statute is successful in meeting these two problems.

Section 732(a) preserves the potential gain or loss by providing that in the case of a property distribution the partner's adjusted basis for the property will be the partnership's adjusted basis. This is known as a carryover basis. Correlatively, section 733(2) requires a reduction in the adjusted basis of the partner's partnership interest in the amount of the basis of such property. This treats the partner as having received a return of capital to the extent of the partnership's adjusted basis in the property. The effect of sections 732(a) and 733(2) is to shift basis from the partnership interest to the property. In a case where the basis of the partnership interest is less than the partnership's adjusted basis of the property, section 732(a)(2) limits the adjusted basis of the property in the hands of the partner to the amount of the adjusted basis of his partnership interest. The effect of this limitation is to either increase the potential gain on disposition of the property or decrease the potential loss. Further, the partner's adjusted basis for his partnership interest would be reduced to zero pursuant to section 733(2). This is the price the partner pays for not having recognition on a current property distribution.

*Guaranteed Payments of Partnerships*⁵⁵

Section 707(a) contemplates that a partner can enter into a transaction with his partnership in a capacity other than that of a partner. The regulations under section 707 provide, *inter alia*:

A partner who engages in a transaction with a partnership other than in his capacity of a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, a sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership.⁵⁶

54. INT. REV. CODE OF 1954, §§ 732(a)(1) and 733(2).

55. See generally WILLIS 162-171.

56. Treas. Reg. § 1.707-1(a) (1958). The general rule that a partner can deal with

Two of the above transactions will be considered here: First, the partner as a creditor of the partnership, and second, the partner as an employee of the partnership.

Section 707(c) sets up a general rule for the taxation of "guaranteed payments"⁵⁷ by a partnership to a partner acting in the capacity of an employee or creditor:

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and to section 162(a) (relating to trade or business expenses).

The crucial element in section 707(c) is the first clause: "To the extent determined without regard to the income of the partnership" This element distinguishes guaranteed payments from regular property distributions which have no tax impact on the partnership⁵⁸ and, in general, generate return of capital treatment to the partner⁵⁹ with a concomitant reduction in the basis of his partnership interest.⁶⁰ Payments to a partner who is acting in the capacity as an employee or creditor will, however, be treated as property distributions if such payments are determined by reference to the income of the partnership. Such payments must be made by the partnership without reference to its income in order for the partner-employee or creditor to be required to include the payment in his gross income under section 61 and for the partnership to get a deduction under section 162 in the case of a salary, and section 163 in the case of an interest payment.

One might ask why salary or interest payments would ever be structured as section 707(c) guaranteed payments since the partner will have gross income, whereas if such payments were property distributions the partner would, in general, be given return of capital treatment. One of the reasons for providing for guaranteed payments is to properly reflect the economic substance of the business bargain between the partners.

For instance, if the AB partnership is formed with B contributing \$100K in cash and A contributing no property or cash but agreeing to perform services for the partnership in exchange for a 50% interest in profits, and a \$10K guaranteed payment each year to partially compensate him for his efforts, the following results would appear to obtain, assuming that the partnership operated at the break-even point before taking account of A's \$10K salary. A would have income pursuant to section 707(c) in the amount of \$10K, and the partnership would get a deduction under section 162 for such payment; generating a loss of \$10K. All the loss would be allocated to B since his distributive share of losses is 100% and he would, therefore, get a deduction of \$10K. This result is in conformity with the economic,

the partnership in a capacity other than partner is subject to exceptions provided for in section 707(b) concerning certain sales or exchanges of property. Section 707(b)(1) disallows a deduction for certain losses on sales of property between a partner and his partnership. Section 707(b)(2) treats certain gains on sales of property between a partner and his partnership as ordinary income rather than capital gain.

57. Section 707(c) is entitled "Guaranteed Payments."

58. INT. REV. CODE of 1954, § 731(b).

59. INT. REV. CODE of 1954, § 731(a)(1).

60. INT. REV. CODE of 1954, § 733.

substance of the business bargain. A has received a \$10K salary payment which he is required to include in gross income under section 61. B provided the capital with which A was paid. B's capital investment in the partnership has been reduced by \$10K, and he receives the tax benefit of the loss deduction in respect of such reduced capital investment and will reduce the adjusted basis for his partnership interest by \$10K.⁶¹

If, however, A's salary had been treated as a property distribution, the partnership would not have received a deduction,⁶² and A would have had a \$10K capital gain by reason of the fact that the \$10K distribution would exceed the adjusted basis for his partnership interest.⁶³ The partnership would have broken even and B would *not* have received the benefit of a deduction in respect of the \$10K distribution to A.⁶⁴

In a case where each of the partner's distributive shares of losses and profits, and their salary and interest payments are in the same relative proportions, the tax impact of structuring the salary and interest payments as guaranteed payments would, in general, be the same as the tax impact of structuring them as property distributions.⁶⁵ For instance, assume that in the AB equal partnership each partner contributes \$50,000 in cash, and each draws a \$10K salary as a guaranteed payment. Assume further that the partnership breaks even at the end of its first year of operations before deducting the guaranteed payments. In such case, the following results would obtain. First, each partner would have gross income under section 61 in the amount of \$10K.⁶⁶ Second, the partnership would have a deduction for salaries of \$20K⁶⁷ which would produce a \$20K loss. Third, each partner would deduct \$10K as his distributive share of partnership loss.⁶⁸ Fourth, each partner would reduce the adjusted basis of his partnership interest from \$50K to \$40K.⁶⁹ The \$10K of ordinary income under section 707(c) would be offset by the \$10K loss deduction, leaving each partner with a net gross income from the partnership of zero.

The same result would obtain in a case where each partner withdrew \$10K as a property distribution. First, the partnership would have broken even and there would be no distributive shares of profits or losses. Second, each partner's receipt of \$10K would be treated as a return of capital, not

61. INT. REV. CODE of 1954, § 705(a)(2)(A).

62. INT. REV. CODE of 1954, § 731(b).

63. INT. REV. CODE of 1954, § 731(a)(1). If the partnership had collapsible items the portion of the gain attributable to such items would be ordinary income. See text accompanying notes 49-50, *supra*.

64. The adjusted basis of B's partnership interest would remain at \$100K; however, other things being equal, the partnership would only have \$90K of assets, by reason of the \$10K distribution to A. B would therefore have an unrealized loss which he would recognize pursuant to section 741 on sale of his partnership interest. Also he would recognize the loss on liquidation of the partnership provided he only received cash on the liquidation. INT. REV. CODE of 1954, § 731(a)(2).

65. If a partner were in a tax bracket higher than 50%, there would be an advantage to having salary payments structured as 707(c) guaranteed payments, because pursuant to section 1348 the maximum tax rate on salaries is 50% whereas the maximum rate on a partner's distributive share of partnership profits is 70%.

66. INT. REV. CODE of 1954, § 707(c).

67. INT. REV. CODE of 1954, § 707(c).

68. INT. REV. CODE of 1954, § 702(a).

69. INT. REV. CODE of 1954, § 705(a)(2)(A).

income.⁷⁰ Third, each partner would reduce the adjusted basis of his partnership interest by \$10K.⁷¹ Fourth, there would be no impact on the partnership from the distribution.⁷²

If profits, losses, salaries and interest are not in the precise relative proportions, then the results under section 707(c) will be different from the results under the property distribution rules. In general, the section 707(c) results would be a more accurate reflection of the economic substance of the business bargain.

A possible advantage of having a partner-employee receive a guaranteed salary payment is that, pursuant to section 1348, salaries are subject to a maximum tax rate of 50%, whereas other ordinary income can be taxed at rates up to 70%. Consequently, if a partner is in a tax bracket higher than 50%, it would be to his advantage to receive partnership income in the form of a guaranteed payment rather than as a distributive share of profits.

II. TAXATION OF SUBCHAPTER C CORPORATIONS AND SHAREHOLDERS

1. *The General Scheme.*

The term "corporation" is defined in section 7701(a)(3) to include "associations, joint stock companies, and insurance companies."⁷³ The term is broad enough to include professional service corporations whose shareholders⁷⁴ are professional employees, such as doctors, lawyers or dentists. Traditionally professional businesses have been conducted in the partnership form. Because of certain tax advantages of operating in the corporate form, it may be advantageous for professionals to incorporate their businesses. One of the principal tax advantages relates to deferred compensation plans which are available to shareholder-employees, but not available to partner-employees. For a long period, the Commissioner attempted to have such corporations classified as partnerships for tax purposes. However, taxpayers won a series of cases on the issue, and the Commissioner has capitulated and accepts such entities as corporations provided certain requirements are met.⁷⁵

The professional service corporation is, in essence, the converse of a limited partnership. Whereas a limited partnership can be used as a vehicle to secure the corporate characteristics of limited liability and centralized management, while maintaining partnership status for federal income tax purposes,⁷⁶ a professional service corporation is a vehicle for securing cor-

70. INT. REV. CODE of 1954, § 731(a)(1).

71. INT. REV. CODE of 1954, § 733(1).

72. INT. REV. CODE of 1954, § 731(b).

73. For a discussion of the difference between a corporation and partnership see note 9, *supra*.

74. The term "shareholders" is defined in Section 7701(a)(8) to include "a member of an association, joint stock company, or insurance company."

75. Rev. Rul. 70-101, 1970-1 CB 278. One of the leading cases in which the taxpayers prevailed was *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969). See generally BITTKER and EUSTICE 2-13.

76. A corporation's taxable income like an individual's taxable income is defined in sections 61 to mean gross income, minus the deductions allowed [by the income tax provisions]."

porate treatment for federal income tax purposes, while retaining the basic partnership characteristics of doing business.

Section 11 imposes a tax on the taxable income of corporations for the year in which the income is earned. Dividend distributions out of earnings and profits,⁷⁷ which are in general a corporation's after tax earnings, are required to be included in the gross income of the shareholder pursuant to section 301(c)(1). In the case of an individual shareholder such dividends will be subject to taxation under section 1.⁷⁸ The character of income at the corporate level does not pass through in dividend distributions. All dividends, whether distributed out of a corporation's capital gains, tax-exempt income, or ordinary income, are treated as ordinary income to the shareholder.

The section 11 tax on corporations consists of a normal tax of 22% on all the corporation's taxable income and a surtax of 26% on the taxable income in excess of \$25,000. Thus, the first \$25,000 of taxable income is taxed at the 22% rate and any excess is taxed at the 48% rate. The capital gains of a corporation will be taxed at preferred rates, the maximum of which is 30%⁷⁹ unless such gains are above a certain level.⁸⁰ Because the corporate tax has a one-step progression which taxes each dollar of ordinary income over \$25,000 at a 48% rate, and each dollar under \$25,000 at 22%, shareholders may be motivated to form multiple corporations in order to spread the taxable income among several corporations in order to take advantage of the 22% rate. There are, however, several weapons in the Commissioner's arsenal for combatting the use of multiple corporations as vehicles for minimizing the impact of the section 11 tax.⁸¹

Under section 1 the dividends of an individual shareholder can be taxed at statutory rates varying from 14%⁸² to 70%, depending on the shareholder's status and tax bracket. The combination of the maximum rates under sections 11 and 1 could produce an effective tax rate of 84.40%⁸³ This rate would obtain in a case where a corporation's earnings were subject to the 48% rate, yielding a \$48 tax on each \$100 of the taxable income, and

For a detailed discussion of the method of calculating a corporation's taxable income see BITTKER & EUSTICE, chapter 5.

77. For a more thorough discussion of "earnings and profits", see the text accompanying notes 85-94, *infra*. Section 116 provides an exclusion in the amount of \$100 for dividends received by individuals.

78. Dividends will only be subject to taxation if the shareholder has taxable income. Individual shareholders are entitled to exclude the first \$100 of dividend income from their gross income pursuant to section 116.

79. Section 1201(a) provides in essence that the excess of net long term capital gains over net short term capital loss will be taxed at the lower of (1) the rates provided by section 11, or (2) 25% in the case of the first \$50,000 of such gains and 30% of the excess. Beginning in calendar year 1975 the rate under section 1201 will be a flat 30%.

80. Capital gains above a certain level will be subject to the section 56 penalty tax on tax preferences.

81. INT. REV. CODE of 1954, §§ 269, 1551, 1561, 1562, 243(b). See generally BITTKER and EUSTICE 15-1 to 15-49.

82. The effective rate could be lower than 14% in the case where the individual's taxable income was less than the amount of dividends included in gross income.

83. For a discussion and tables comparing the tax rates of operating a business as a corporation with the rates applicable to a sole proprietorship see BITTKER & EUSTICE 1-5 to 1-12.

the after tax proceeds were distributed as dividends and subject to a 70% rate, yielding a tax of \$36.40. The aggregate tax would be \$84.40 on each \$100 of earnings.

The taxation of both the corporation and the shareholders is known as the double tax. This should be contrasted with the scheme for taxing partnerships, under which the partners and not the partnership are subject to taxation.

Because of the potential high cost of the double tax, shareholders may be motivated to accumulate earnings in a corporation, thereby eliminating an immediate tax at the shareholder level and maximizing the amount of money available for investment. Another incentive for accumulating earnings is that on sale of stock the gains attributable to such accumulated earnings will, in general, be subject to capital gains rates rather than ordinary income rates. Further, on death of the shareholder the tax on such gains will be completely eliminated because pursuant to section 1014(a) the beneficiary of the deceased shareholder would take the stock at a basis equal to the fair market value at the date of death. Another motive for accumulating earnings would be the possibility of a sale of the corporation in a tax-free reorganization pursuant to section 368.

2. *The Accumulated Earnings Tax and The Personal Holding Company Tax*⁸⁴

In order to prevent accumulations of earnings in a corporation for the purpose of avoiding the tax at the shareholder level, Congress has provided for an accumulated earnings tax and a personal holding company tax. Both taxes are designed to prod corporations into making distributions of earnings by exacting a penalty tax for certain accumulations. They are constraints against the avoidance of the double tax. The accumulated earnings tax may apply to every corporation, except corporations which are subject to the personal holding company tax and certain other corporations which are not relevant to the discussion here. The personal holding company tax may attach to certain corporations which are engaged in passive business activities, such as the holding of securities. The two taxes are mutually exclusive.

Section 532(a) provides that a corporation will not be subject to the accumulated earnings tax unless it is

. . . 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. (emphasis added).

Section 533 sets out a rule for determining whether a corporation is "formed or availed" for the prohibited purpose:

[T]he fact that the earnings and profits of a corporation are permitted to accumulate *beyond the reasonable needs of the business* shall be de-

84. The discussion that follows is very general, and is designed to simply lay out the basic statutory framework. For a detailed discussion of the accumulated earnings tax and the personal holding company tax see BITTKER & EUSTICE, ch. 8. The accumulated earnings tax provisions are sections 531 to 537 and the personal holding company tax provisions are section 541 to 558. Provisions common to the two taxes are sections 561 to 565.

terminative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary. (emphasis added).

Section 537 provides standards for determining whether accumulations are for the reasonable needs of the business. However, the question is one of fact which will be dependent on the particular circumstances in each case. The regulations under section 533 make it clear that the reasonable needs of the business test is not the exclusive test for determining a purpose to avoid the income tax with respect to shareholders.

If the Commissioner determines that an accumulation is unreasonable, section 533 places the burden on the corporate taxpayer to prove by a preponderance of the evidence that the accumulation is not unreasonable. Section 534, however, sets up a method whereby the corporate taxpayer can shift the burden of proof to the Commissioner. If a corporation is a mere holding or investment company, section 533(b) provides that such fact "shall be prima facie evidence of *the purpose* to avoid the income tax with respect to shareholders", and consequently such corporations will automatically be subject to the accumulated earnings tax.

The tax is imposed by section 531 on the "accumulated taxable income" of every corporation which is subjected to the tax and is equal to the sum of:

- (1) 27½ percent of the accumulated taxable income not in excess of \$100,000, plus;
- (2) 38½ percent of the accumulated taxable income in excess of \$100,000.

Accumulated taxable income is defined in section 535. Basically it is an amount equal to taxable income minus both the taxes paid in respect of such income and dividend distributions. Additional adjustments are set out in section 535(b).

Section 535(c) provides for an accumulated earnings credit. This credit shields a certain amount of corporate earnings from the accumulated earnings tax. In the case of a corporation which is *not* a mere holding or investment company, the accumulated earnings credit is equal to the greater of \$100,000, or an amount equal to the part of the accumulated earnings which are retained for the reasonable needs of the business. Such corporations can accumulate in excess of \$100,000, provided such accumulations are for the reasonable needs of the business. In the case of a mere holding or investment company, the accumulated earnings credit is limited to a flat \$100,000.

A corporation can avoid having its earnings subjected to the accumulated earnings tax without distributing such earnings, if the corporation agrees to "consent dividends for the taxable year" pursuant to section 565. In essence, consent dividends are a constructive distribution of dividends to the shareholders followed by an immediate constructive contribution to the capital of the corporation in the amount of such constructive distribution. A consent dividend has the effect of taxing the shareholder on the income equal to the amount of the consent dividend and at the same time increasing the shareholder's basis in his stock attributable to the constructive contribu-

tion. Consent dividends are, therefore, treated analogously to a partner's distributive share of profits of a partnership.

The predicate for the imposition of the accumulated earnings tax is an allegation by the Commissioner that a corporation has been used for the purpose of avoiding the income tax. Consequently, unlike the section 11 tax on taxable income, the accumulated earnings tax is not a self-assessed tax. It might, therefore, be economically advantageous for a corporation to accumulate earnings beyond its reasonable needs and hope that the Commissioner will not claim that such accumulations are unreasonable.

The personal holding company tax is directed at corporations which are closely held and engaged in passive income activities. A solely owned corporation in the business of holding and selling stock and securities might very well be a personal holding company. The personal holding company tax is equal to 70% of the "undistributed personal holding company income" of every personal holding company.

Personal holding companies are defined in sections 542(b); basically, there are two requirements for characterization as a personal holding company. First, more than 50% of the value of the outstanding stock of the corporation must be owned directly or indirectly by five or fewer individuals. Second, 60% of the corporation's "adjusted ordinary gross income" must constitute "personal holding company income." Adjusted ordinary gross income is defined in section 543(b)(2) to mean, gross income minus the sum of (1) certain gains, and (2) expenses attributable to rents, royalties, interest, etc. Personal holding company income, in general, includes dividends, certain rents, royalties, and income from personal service contracts. Pursuant to the rules of section 543(b), if the rental income is a substantial part of the corporation's gross income, such rents may not be deemed to be personal holding company income. Other things being equal, an operating real estate corporation would not, therefore, be subject to the personal holding company tax.

Income from personal service contracts may cause a professional service corporation to be classified as a personal holding company. Pursuant to section 543(a)(7), income from the rendering of professional services will be deemed to be personal holding company income if the client has the right to designate the professional who will perform the services.

The 70% tax does not attach simply because the corporation is a personal holding company. The tax is only imposed on undistributed personal holding company income, which is defined in section 545(a) to mean, the after tax income of the corporation, minus the sum of (1) the dividends paid during the year, and (2) any consent dividends.

Because of the harshness of the 70% tax rate, section 547 provides for a deduction for "deficiency dividends." Deficiency dividends are a method for permitting a corporation that is determined to be a personal holding company to distribute dividends from accumulated personal holding company income and thereby avoid the personal holding company tax. The mitigation provided by deficiency dividends, however, does not extend to interest and other tax penalties which accrue in respect of the accumulation of personal holding company income.

There is a continuum of harshness with respect to the accumulated earnings tax and the personal holding company tax. Personal holding companies are on one pole of the continuum, and other corporations which are *not* mere investment or holding companies are on the other. Mere investment or holding companies are in the middle. The penalty for accumulations by personal holding companies is very harsh, 70%, subject to a distribution of deficiency dividends. The penalty for mere holding or investment companies is the same as the penalty for other corporations, 27½% on accumulations up to \$100,000, and 38½% on accumulations in excess of \$100,000. However, the base for the tax is lower, for the tax will attach in all cases after accumulations exceed the \$100,000 credit. The penalty on accumulations of corporations which are neither personal holding companies nor mere holding or investment companies does not attach, in any event, on accumulation not in excess of \$100,000, and will *not* attach on accumulations in excess of \$100,000 unless such excess accumulations are unreasonable.

3. *Current Distributions of Cash and Property by Subchapter C Corporation*

Section 301(c)(1) requires that the amount of a current distribution⁸⁵ which constitutes a dividend must be included in the gross income of the shareholder.⁸⁶ In the case of an individual shareholder⁸⁷ such dividends will be subject to tax under section 1.⁸⁸ The term "dividend" is defined in section 316 to mean:

- Any distribution of *property* made by a corporation to its shareholders—
 (1) out of its [*accumulated*] *earnings and profits* . . . , or
 (2) out of its [*current*] *earnings and profits* (emphasis added)

85. Current distributions as used here refers to dividend distributions and redemptions which are treated as dividend distributions. Current distributions by corporations are broader than the current distributions by partnerships because certain redemptions of stock may be treated as current distributions for dividend purposes.

86. Section 301(a) provides that all distributions of property made by a corporation shall be treated in the manner provided in subsection (c) of section 301. Section 301(b) defines the amount distributed. In the case of shareholders other than corporations such amount is the fair market value of the property distributed plus the money distributed, section 301(b)(1)(A). In the case of corporate shareholders the amount distributed is equal to the adjusted basis of the property in the hands of the distributor corporation increased by the gain recognized by the distributor corporation from such distribution plus the amount of money distributed, section 301(b)(1)(B). Further, specific rules are set out for determining the amount distributed by foreign corporations, section 301(b)(1)(C), and to foreign corporate shareholders, section 301(b)(1)(D).

Section 301(c)(1) provides that to the extent the amount distributed, as determined in section 301(b), constitutes a dividend, as defined in section 316, such amount shall be included in the shareholder's gross income. The amount distributed which does not constitute a dividend will reduce the adjusted basis of the shareholder's stock pursuant to section 301(c)(2), and any excess over the adjusted basis is, in most cases, considered gain from the sale or exchange of the stock, section 301(c)(3)(A). Such gain will normally be capital gain.

The basis of the property received in a distribution is determined under section 301(d), and in the case of an individual shareholder is the fair market value of the property, section 301(d)(1), and in the case of a corporate shareholder is the lesser of the fair market value or the adjusted basis to the distributor corporation increased by the distributor's gain on the transaction, section 301(d)(2). The basis in the case of a foreign corporate shareholder is determined under section 301(d)(3) and in the case of certain corporate distributees of foreign corporation under section 301(d)(4).

87. The discussion hereinafter will assume that the shareholders are individuals.

88. Pursuant to section 116 the first \$100 of dividend income is excluded from gross income.

The term property⁸⁹ includes both cash and other property, and the amount of a distribution to an individual shareholder is equal to the amount of cash distributed plus the fair market value of property distributed.⁹⁰ The measure of whether a distribution will be a dividend is the corporation's "earnings and profits", a term which is not defined in the Code.⁹¹ Basically it refers to the earnings of a corporation after operational expenses and taxes; it is similar to but not completely analogous to the financial accounting concept of income. It is important to note, however, that it does not refer to the liquid funds in a corporation.

Earnings and profits will be positive if the corporation operates at a profit and negative if it operates at a loss, the latter being commonly referred to as a deficit in earnings and profits. Although the term is not defined, section 312 specifies the effect certain transactions will have on earnings and profits. Pursuant to section 312 earnings and profits are, in general, reduced (but not to a deficit) by the amount of money distributed and the adjusted basis of property distributed.

Current earnings and profits is the earnings of the current tax year. Accumulated earnings and profits is the undistributed earnings and profits of prior tax years and is similar to, but not completely analogous to, the financial accounting concept of retained earnings. Unless distributed, current earnings and profits will become accumulated at the end of a tax year. It is possible, of course, for accumulated earnings and profits to be positive while current earnings and profits are negative or vice versa.⁹² Section 316 provides that distributions are considered to be out of the most recent earnings and profits.

The following is a simplified example of the calculation of a corporation's current earnings and profits. Assume that an accrual basis corporation had gross income for the taxable year of \$1,000,000, tax-exempt income of \$10,000, operating expenses of \$500,000 and a tax liability of \$250,000.⁹³

89. The term "property" is defined in section 317(a) to mean:

Money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

Distributions of a corporation's own stock or rights, otherwise known as stock dividends, are beyond the scope of this article.

90. See, e.g. note 86, *supra*.

91. For a detailed discussion of the meaning of earnings and profits see BITTKER and EUSTICE 7-9.

92. Section 316(a)(1) provides that current earnings and profits are calculated ". . . without diminution by reason of distributions made during the current year . . .". The section further provides that except where otherwise provided all distributions shall be first considered as made out of current earnings and profits. This raises the following anomaly. If a corporation (1) has a deficit in its accumulated earnings and profits account of \$100K, (2) has current earnings and profits of \$10K, and (3) distributes \$10K during the current year, such distribution would be treated as a dividend. On the other hand, if the \$10K was distributed in the following year (at which time it would have become accumulated and have reduced the deficit to \$90,000) there would be no dividend unless the corporation had current earnings and profits in such year.

93. The tax accounting method used to compute earnings and profits must be the same as that used in computing taxable income. Consequently, in computing current earnings and profits a cash basis corporation will deduct the taxes actually paid without regard to the tax year of the liability. An accrual basis taxpayer will deduct the taxes owed for the current year although such taxes may not be paid until the following year.

The corporation's current earnings and profits would be \$260,000, calculated as follows:

Gross Income	\$1,000,000	
Tax-Exempt Income ⁹⁴	10,000	
	<u>\$1,010,000</u>	
		\$1,010,000
Operating Expenses	500,000	
Taxes	<u>250,000</u>	
		750,000
Current Earnings and Profits		<u>\$ 260,000</u>

If the corporation were to distribute cash of \$260,000 or property of a like value the shareholders would have a dividend in such amount.

Any distribution in excess of the current earnings would be deemed to be out of accumulated earnings and profits to the extent thereof.⁹⁵ Any distributions in excess of both current and accumulated earnings and profits would be treated as a return of capital to the extent of the shareholders adjusted basis for his stock.⁹⁶ Anything in excess of such adjusted basis would be treated as gain.⁹⁷ For example, if a corporation has \$260K in current earnings and profits, \$10K in accumulated earnings and profits, and distributes \$300K to its sole shareholder who has a basis in his stock of \$20K, the following results would obtain. \$260K would be a dividend from current earnings and profits. The \$40,000 portion in excess of current earnings and profits would be deemed to be out of accumulated earnings and profits to the extent of \$10K. The \$30K portion in excess of such accumulated earnings and profits would be a non-taxable return of capital to the extent of the shareholder's adjusted basis for his stock which is \$20K. The \$10K portion which is in excess of the adjusted basis of the shareholder's stock would be treated as gain from the sale of such stock. These results can be summarized by reference to four levels of distribution:

- First Level Distributions are first deemed to be out of current earnings and profits.⁹⁸
- Second Level Distributions in excess of current earnings and profits are deemed to be out of accumulated earnings and profits.⁹⁹
- Third Level Distributions in excess of both current and accumu-

94. Tax-exempt income will increase earnings and profits because it is money that the corporation has available for distribution to its shareholders. Treas. Reg. § 1.312-6(b) (1955). Although such interest is tax-exempt to the corporation, the tax-exempt character is lost on distribution. This should be contrasted with the treatment of tax-exempt interest earned by partnerships. Such interest is tax-exempt to the partners and increases the adjusted bases of their partnership interest pursuant to section 705(a)(1)(B). See text accompanying notes 92 & 93, *supra*.

Tax-exempt interest is an example of an item which is excluded from taxable income but included in earnings and profits. Certain items, such as the excess of accelerated depreciation over straight line, will reduce taxable income but not earnings and profits, section 312(m).

95. INT. REV. CODE of 1954, § 316(a).

96. INT. REV. CODE of 1954, § 301(c)(2). See, e.g., note 1, *supra*.

97. INT. REV. CODE of 1954, § 301(c)(3).

98. INT. REV. CODE of 1954, §§ 316, and 301(c)(1).

99. INT. REV. CODE of 1954, §§ 316, and 301(c)(1).

lated earnings and profits are deemed to be a non-taxable return of capital to the extent of the adjusted basis of the shareholder's stock.¹⁰⁰

Fourth Level Distributions in excess of current and accumulated earnings and profits and the adjusted basis of the shareholder's stock will normally produce a capital gain.¹⁰¹

Pursuant to section 311 current distributions of property are not normally taxable events to corporations.¹⁰² Consequently, in general, a corporation which has an appreciated asset can avoid gain in respect of such asset by distributing it as a dividend to its shareholders. The shareholders would have a dividend in the amount of the fair market value of the property limited to the corporation's earnings and profits.¹⁰³ Further, the shareholders' adjusted bases for such assets would be equal to the fair market value so that there would be no gain in respect of such appreciation when the shareholders sold the assets.¹⁰⁴ Also, a distribution of appreciated property will not normally generate earnings and profits.¹⁰⁵

4. Mitigation of the Double Tax

The tax on the taxable income of a corporation plus the tax on earnings and profits when distributed to the shareholders can be mitigated in a case where a shareholder is also an employee or creditor of the corporation.¹⁰⁶ A corporation is allowed a deduction under section 162 for the ordinary or necessary business expenses "paid or incurred" as a "reasonable allowance

100. INT. REV. CODE OF 1954, § 301(c)(2).

101. INT. REV. CODE OF 1954, § 301(c)(3)(A).

102. Section 311(a) reads as follows:

Except as provided in subsections (b), (c), and (d) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

- (1) its stock (or rights to acquire its stock), or
- (2) property.

The exception in 311(b) to the general rule of nonrecognition applies to distributions of certain inventories. The exception in section 311(c) gives the corporation recognition in respect of a distribution of property subject to certain liabilities, and section 311(d) gives the corporation recognition for certain property distributions in redemption of stock. Pursuant to section 453(d) a corporation will recognize gain on the distribution of installment obligations.

In addition to the above statutory exceptions there is a common law exception which was first adopted by the Supreme Court in *Commissioner v. Court Holding*, 324 U.S. 331 (1945) *rev'd*, 143 F.2d 823 (5th Cir. 1944). There a corporation negotiated a sale of its property but before consummating the sale distributed the property to its shareholders who completed the sale. Although the predecessor to section 311 was not in the statute the Supreme Court had previously held in *General Utilities & Operating Co. v. Helvering*, 96 U.S. 200 (1935), *rev'd*, 74 F.2d 972 (4th Cir. 1935), that a corporation does not recognize income on a distribution of appreciated property. In *Court Holding* the court carved out an exception to this general principle in situations where the corporation negotiates the sale and then distributes property which the shareholders sell. In such cases the corporation will have income by reason of the imputation of the sale to the corporation. *But see* *United States v. Cumberland Service*, 338 U.S. 451 (1950), *aff'd* 83 F. Supp. 843 (Ct. Cl. 1949). For a detailed discussion of the effect of property distributions see BITTKER and EUSTICE 7-39 to 7-58.

103. INT. REV. CODE OF 1954, §§ 301(c)(1) and 316.

104. INT. REV. CODE OF 1954, § 301(d), *but see* discussion of *Court Holding* in note 102, *supra*.

105. *But see*, INT. REV. CODE OF 1954, § 312(b) and (c).

106. It can also be mitigated in a case where the shareholder is the lessor of property to the corporation.

for salaries or other compensation for personal services actually rendered." Under section 163 a corporation is allowed a deduction for "all interest paid or accrued within the taxable year on indebtedness." Salary and interest payments reduce the corporation's taxable income. Correlatively, salary payments constitute gross income to employees under section 61, and interest is gross income to the creditors. This treatment of salaries and interest should be compared with the treatment of dividends. Dividends are not deductible by the corporation in computing its taxable income, but they are income to the shareholder under section 1. Consequently, dividends are subject to a tax at both the corporate and shareholder levels, whereas salary and interest payments to employees or creditors are not subject to a tax at the corporate level.

There is no prohibition against a shareholder of a corporation also being an employee or creditor of the corporation. One person can act in several different capacities vis-a-vis his relationship with one entity. The extreme case occurs when one person is sole shareholder, sole creditor and sole employee. Given this metaphysical concept of the person as a troika and the major tax advantage of the salary and interest deduction, the question naturally arises whether a salary or interest payment to a shareholder is in substance a dividend.

As one would suspect, there are constraints on the use of both salary and interest payments. If salary payments are unreasonable the corporation will be denied the deduction but the payments will still be included in the gross income of the shareholder-employee. If a debt instrument is not a bona fide indebtedness, interest payments in form will be considered dividend payments in substance, and the corporation will be denied a deduction while the payment will be included in the gross income of the shareholder-creditor. These constraints are discussed in more detail below.

At first blush, it might seem as though it would always be best for a shareholder-employee or shareholder-creditor to take money out of his corporation in his capacity as either an employee or creditor rather than as shareholder. This is generally true in a case where the corporation has sufficient taxable income to offset such payments. In a case where the corporation is operating at a loss, however, the salary paid to a shareholder-employee and the interest paid to a shareholder-creditor may not generate an immediate tax benefit to the corporation since the corporation does not have sufficient income to offset the deduction. To the extent such payments generated an operating loss the corporation could under section 172 carry back the loss three years and forward five. Notwithstanding the possible absence of a tax benefit at the corporate level such payments are gross income to the employee and creditor. Thus, although payments received as an employee or creditor can avoid the double tax in a case where a corporation is operating at a profit, such payments will also generate a single tax in a case where the corporation is operating at a loss, whereas if the funds were taken out of the corporation as a distribution in respect of the stock they would, in general, be given return of capital treatment. The double tax can be completely avoided when the payments to the shareholder-employee or shareholder-creditor reduce the corporation's taxable income to zero. In

such case, there would be only one tax on the earnings of the entity and that tax would be imposed on the shareholder in his capacity as employee or creditor.

Although salary and interest payments can be theoretically structured to eliminate the double tax, other factors might make it uneconomical to do so. For instance, if the shareholder is in the 70% tax bracket by reason of the receipt of taxable income from other sources, any salary or interest he receives from the corporation will be taxed at the 70% rate. If, however, the salary and interest was not paid, the corporation's tax on such retained funds would be a maximum of 48%. Of course, there are constraints against accumulating earnings in a corporation. If such accumulations are unreasonable the accumulated earnings tax might attach, and if the corporation is a personal holding company, the personal holding company tax would attach.¹⁰⁷ The question of whether it would be advantageous for a shareholder to receive a salary or interest from a corporation as opposed to dividends will be dependent on numerous variables, some of which are as follows:

- (1) The taxable income of the shareholder from sources other than the corporation;
- (2) The tax bracket of the corporation;
- (3) Whether the corporation is a personal holding company;
- (4) The likelihood that the corporation would be subject to the accumulation earnings tax.

As a general proposition the tax cost of extracting earnings from a profitable corporation will be less if the payments are structured as salaries or interest rather than dividends.

In order for salaries to qualify for the section 162 ordinary and necessary business expense deduction, they must be "reasonable", otherwise they may be given dividend treatment. The regulations make it clear that salary payments by closely held corporations to shareholder-employees will be given particular close scrutiny for the purpose of determining whether such salaries are disguised dividends:

[A]n ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not wholly for services rendered but that the excessive payments are a distribution of earnings upon the stock.¹⁰⁸

The regulations also address the affect of the method of determining compensation on the question of deductibility:

The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on

107. See text accompanying note 84, *supra*.

108. Treas. Reg. § 1.162-7(b)(1) (1958).

any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.¹⁰⁹

This regulation is designed to limit the possibility of tax avoidance through the use of compensation agreements which permit the shareholder-employee to calculate the amount of his salary after determining the level of the corporation's income. This is a constraint on the *ex post facto* elimination of the double tax. Of course, as the regulation points out if contingent compensation agreements are in essence arms length transactions they "may" be given bona fide treatment for purposes of section 162. The point that such agreements "may," but not necessarily will, be given such treatment is a function of the penultimate question of reasonableness:

In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amounts as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made and not those existing at the date when the contract is questioned.¹¹⁰

The test of reasonableness, as one would suspect, has spawned numerous cases, an exploration of which is beyond the scope of this paper. Suffice it to say that the question of how much of a salary can be paid without giving rise to a claim of dividend is determined by the particular facts and circumstances.

The question of whether interest payments to a shareholder-creditor are in substance disguised dividends is a major issue to tax law. There is a substantial common law of taxation on the question, the most exhaustive exploration of which is *Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal* by William Plumb.¹¹¹

One writer describes the question as an "embroglio."¹¹² Naturally, this embroglio is beyond the scope of this paper; however, it is imperative to at least probe the perimeter.

In order to help bring more definiteness into this area, in 1969 section 385 was enacted under which the Commissioner is authorized to promulgate regulations which will determine ". . . whether an interest in a corporation is to be treated for purposes of [the CODE] as stock or indebtedness." At the time this article was sent to the printers, the Commissioner had not issued regulations, either proposed or final, pursuant to such authority. This in itself is an indication of the complexity of the issue. Section 385(b) sets out certain factors which the Commissioner may take into account in determining whether an interest in a corporation is stock or indebtedness:

109. Treas. Reg. § 1.162-7(b)(2) (1958).

110. Treas. Reg. § 1.162-7(b)(3) (1958).

111. 26 TAX L. REV. 369 (1971).

112. Note, *Toward New Modes of Tax Decisionmaking—The Debt-Equity Imbroglia and Dislocations in Tax Lawmaking Responsibility*, 83 HARV. L. REV. 1695 (1970).

- (1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or monies worth and to pay a fixed rate of interest;
- (2) Whether there is subordination to or preference over any indebtedness of the corporation;
- (3) The ratio of debt to equity of the corporation;
- (4) Whether there is a convertibility into the stock of the corporation;
- (5) The relationship between holdings of stock in the corporation and holdings of the interest in question.

As a general proposition, it can be said that the more a debt instrument resembles an instrument which a disinterested third party lender may have bargained for in an arms length transaction, the greater the probability the instrument will be considered debt. One benchmark for determining whether a debt instrument is bona fide is whether interest is paid regularly. If during the loss years of a business enterprise interest is not paid, a debt instrument may indeed be viewed as part of the equity of the corporation. While it may be disadvantageous for a corporation to pay interest in a loss year thereby causing the exaction of a tax on the shareholder-creditor with no immediate tax benefit from the deduction, the absence of such payment may cause the debt instrument to be considered equity and thereby eliminate the possibility of the single tax on such payments in future years. The price of the single tax on interest in profitable years may be a tax on such interest in loss years.

Another advantage of the use of debt instruments in structuring the capital of a corporation is the possibility of bailing out earnings as either a return of capital or capital gain on redemption of the instruments. For instance, if a corporation is formed by a sole shareholder who contributes \$100K in cash in exchange for stock with a fair market value of \$50K and bonds with a fair market value and par value of \$50K, the future redemption of the bonds for their par value of \$50K will be treated as a return of capital if the bonds are considered bona fide indebtedness. The shareholder-creditor would, therefore, have the opportunity to bail out \$50K of the corporation's earnings on a tax-free basis. The reason for this is that the taxpayer would have a basis in his bonds of \$50K and the redemption of the bonds would be treated as a sale or exchange under section 1232(b), putting the transaction within section 1001 under which there would be a zero gain since the amount realized on the exchange, \$50K, would be equal to the adjusted basis of the property exchange, \$50K. Such a bailout of earnings avoids the tax at the shareholder level but not the corporate level. It is, the converse of salary and interest payments which eliminate the tax at the corporate but not the shareholder level.

If instead of contributing \$100K in cash, the taxpayer had contributed a building with an adjusted basis of \$50K and a fair market value of \$100K in exchange for \$50K of bonds and \$50K of stock, the basis of each of the bonds and stocks would be \$25K.¹¹³ On the redemption of the bonds for their face value of \$50K the shareholder-creditor would have a \$25K return of capital and a \$25K capital gain by reason of the operation of section

113. INT. REV. CODE OF 1954, § 358(b).

1232(b). In this case the double tax is eliminated to the extent of the return of capital, and what would otherwise have been ordinary income is converted into capital gain.

This result may not obtain, however, if stock is redeemed. Section 302 treats certain redemptions of stock as dividends. For instance, in the case of a sole shareholder, if 50% of the stock is redeemed, the shareholder would still own 100% of the corporation, albeit the outstanding stock would have been reduced by 50%. The fact that a redemption of stock may not change the shareholder's control of the corporation makes the transaction look as though the shareholder had simply received a dividend distribution. Section 302 operates to treat redemptions which are substantially equivalent to dividends as dividends. Although section 302 is beyond the scope of this paper, it is important to at least have an understanding of its purpose.¹¹⁴

Section 302(a) provides that a redemption of stock shall be treated as a sale or exchange and consequently not as a dividend, only if the redemption meets the requirements of section 302(b). Section 302(b) provides for three types of redemptions which are relevant to the discussion here.

First, section 302(b)(3) provides that redemptions which terminate the stock interest of a shareholder shall be treated as a sale or exchange of such stock. This conforms to economic reality, for a termination of a shareholder's interest is not normally analogous to a dividend distribution.

Second, section 302(b)(2) provides that certain redemptions which decrease the shareholder's interest in the corporation by 20% shall be treated as a sale or exchange and not a dividend. This rule also seems to conform to economic reality for it provides for sale or exchange treatment in a case where a shareholder is in effect reducing the amount of his investment in the corporation.

Third, section 302(b)(1) provides that any redemption which is not essentially equivalent to a dividend shall be given sale or exchange treatment. This third provision is a very general test as opposed to the specific tests of section 302(b)(3) and (b)(2). As one would suspect, this general test has spawned quite a bit of common law on the question of what types of redemptions are not essentially equivalent to a dividend. The Supreme Court spoke on the question recently in *Davis v. Commissioner*.¹¹⁵ There the Court held that in order to fit within section 302(b)(1) a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. The Supreme Court's pronouncement with regards to the parameters of section 302(b)(1) is analogous to the policy rationale of sections 302(b)(3) and (b)(2).

The possibilities for tax avoidance by way of redemptions in cases where corporations are controlled by a family group are manifold. For instance, a father could give his son 50% of the stock of a wholly owned corporation and have the corporation then redeem his remaining 50% interest thus meeting the termination of interest requirement of section 302(b)(3). Congress has provided constraints on such tax avoidance schemes, however.

114. See generally BITTKER and EUSTICE 9-1 to 9-36.

115. 397 U.S. 301 (1970).

Section 318 in effect provides that a shareholder may own more stock in a corporation than he actually owns by creating constructive ownership of the stock of related parties such as a wife or child. The attribution rules of section 318 also apply to and from partnerships and partners, corporations and shareholders, estates and beneficiaries, and trust and beneficiaries, with certain specific rules applicable to each entity and the related party. In general section 318 operates to limit the tax avoidance possibilities by treating certain stock redemptions which might otherwise meet the requirements of section 302(b) as redemptions outside such section. For example, section 318 would operate to treat the father in the above hypothetical as the owner of the stock given to the son, and consequently the redemption of the 50% interest would constitute a dividend to him.¹¹⁶

Stock redemptions must run the gauntlet of section 302(b) in order to have the redemption treated as a sale or exchange, thereby giving rise to return of capital treatment to the extent of basis and capital gain thereafter. In the case of a closely held corporation, the gauntlet may be unnegotiable. There is no section 302(b) gauntlet for securities, however, but there is the debt-equity hurdle which must be negotiated. If the hurdle is not negotiated and purported debt will be classified as equity, and a redemption thereof would also be subject to the section 302(b) gauntlet.

In summary, the impact of the double tax can be mitigated in a case where a shareholder is also an employee or creditor of the corporation. In such cases, any salary payments to the shareholder-employee and any interest payments to the shareholder-creditor will be deductible by the corporation, and such payments will be includible in the gross income of the shareholder-employee and the shareholder-creditor. From the shareholder's side of the transaction the same result obtains in the case of dividend distributions, that is, the shareholder is required to include the dividend in his gross income.¹¹⁷ On the corporate side the treatment is different because dividends are not deductible in calculating taxable income. There are certain constraints which must be considered in order to eliminate the double tax through the use of salaries and debt in the planning of a corporate-shareholder relationship. Further, the tax at the shareholder level will be eliminated or converted into a capital gains tax on the redemption of bona fide debt.

III. TAXATION OF SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS¹¹⁸

1. *The General Scheme*

Except in the case of certain long term capital gains,¹¹⁹ the federal in-

116. Pursuant to section 302(c)(2) the family attribution rules of section 318 can be waived for termination. However, section 302(c)(2)(B)(ii) provides an exception in a case where a family member receives (within ten years before a redemption) stock by way of gift from a family member whose interest is redeemed, which is the case here.

117. Assuming a dividend out of earnings and profits.

118. For a discussion of proposals to modify Subchapter S see generally Note, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799 (1971) and BITTKER AND EUSTICE 6-36 to 6-38.

119. INT. REV. CODE OF 1954, § 1378.

come tax is not imposed on Subchapter S corporations;¹²⁰ it is imposed on the shareholders of such corporations.¹²¹ Also the net operating loss of a Subchapter S corporation will, in general, pass through to the shareholders.¹²² Although the tax treatment is similar to that of partnerships, Subchapter S corporations have the same characteristics and are subject to the same provisions of the Code as Subchapter C corporations, except where otherwise expressly provided in Subchapters S.¹²³ A Subchapter S corporation has, for instance, both a current and accumulated earnings and profits account, and just as it is necessary to distinguish earning and profits from taxable income of Subchapter C corporations it is also necessary to make the distinction for Subchapter S corporations. Further, the life cycle of a corporation may include periods when it is taxed as a Subchapter C corporation as well as a Subchapter S, and in a case where a Subchapter C corporation becomes a Subchapter S, the latter will have the same accumulated earnings account as the former.

There are several prerequisites for qualifying for tax treatment as a Subchapter S corporation. Although a thorough discussion of these prerequisites is beyond the scope of this article, it is necessary to discuss the more important prerequisites. The starting point is qualification as a "small business corporation" pursuant to section 1371(a):

For purposes of this subchapter, the term small business corporation means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

- (1) have more than 10 shareholders;
- (2) have as a shareholder a person (other than an estate) who is not an individual;
- (3) have a nonresident alien as a shareholder; and
- (4) have more than one class of stock.

There are no size restrictions on a Subchapter S corporation; each of the restrictions in section 1371(a) relates to the form of the corporation (it must be domestic and not a member of an affiliated group), or the form of the ownership interests (only one class of stock), or the number and type of shareholders (no more than 10, all of whom are either individuals or estates, and none of whom is a nonresident alien).¹²⁴

The Commissioner has in the past used the one class of stock requirement to disqualify an otherwise qualified Subchapter S corporation on the grounds that purported debt in such corporation was in substance equity and

120. INT. REV. CODE of 1954, § 1372(b)(1).

121. INT. REV. CODE of 1954, § 1373(a).

122. INT. REV. CODE of 1954, § 1374(a).

123. Treas. Reg. § 1.1372-1(c) (1968) provides:

To the extent that the other provisions [the income tax provisions] of the Code are not inconsistent with those under Subchapter S . . . and the regulations thereunder, such provisions will apply with respect to both the [Subchapter S corporation] and its shareholders in the same manner that they would apply had [the corporation been a Subchapter C corporation].

124. The 10 shareholder limitations can cause particularly disastrous consequences. If a shareholder sells to several individuals or stock passes to several beneficiaries on death of a shareholder, the corporation may lose its status as a Subchapter S corporation. Buy-sell agreements which give the corporation or shareholders or both a first right of refusal before stock is sold or passes on death can be used to prevent the potential disqualification of the corporation.

such equity was a second class of stock. The regulations provide that "[o]bligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock."¹²⁵ However, in a series of cases taxpayers have succeeded in having the regulation declared invalid as applied to their situations,¹²⁶ and the Commissioner has recently stated that he will no longer litigate the question in factually similar cases pending revision of the regulation.¹²⁷

If a corporation meets the test of section 1371(a) it then is eligible to elect pursuant to section 1372(a) not to be subject to the taxes imposed by the income tax provisions of the Code. The validity of the election is subject to the consent of all the shareholders.¹²⁸ The corporate election must be made pursuant to section 1372(c) which requires that the election be made at any time either (1) during the first calendar month of a taxable year, or (2) during the month preceding such first calendar month. There is no requirement that the corporation be specifically organized as a Subchapter S corporation; any small business corporation can elect as long as the election is filed pursuant to section 1372(c). The one exception to this rule applies to a Subchapter S corporation which has had its status either terminated or revoked, in which case section 1372(f) disables the corporation from again electing for a period of five tax years beginning after the tax year of revocation or termination.

The requirement that the election occur within the first calendar month of the corporation's tax year or the preceding month may be a difficult requirement to fulfill in the case of a newly organized corporation. The question arises as to when the taxable year of a newly organized corporation begins. The regulations have this to say on the question:

The first month of the taxable year of a new corporation does not begin until the corporation has shareholders or acquires assets or begins doing business, whichever is the first to occur.¹²⁹

This can be a crucial matter which could return to haunt the shareholders who on audit after the corporation has been operating for three years find themselves faced with the assertion that the corporation is not and has not been a Subchapter S corporation because the election was not timely filed.¹³⁰

A valid election will be terminated, *inter alia*, if the corporation falls without the section 1371(a) definition of a "small business corporation".¹³¹ If a new person becomes a shareholder of the corporation the election will

125. Treas. Reg. § 1.1372-1(g) (1968).

126. See, e.g., *Portage Plastics Co. v. United States*, 470 F.2d 308 (7th Cir. 1973); and *Shores Realty Co., Inc. v. United States*, 468 F.2d 572 (5th Cir. 1972).

127. T.I.R. No. 1248, July, 1973, 7 C.C.H. 1973 STAND. FED. TAX REP. 6754.

128. INT. REV. CODE of 1954, § 1372(a).

129. Treas. Reg. § 1.1372-2(b) (1969).

130. A recent example of this type of tax fiasco took place in *Calhoun v. United States*, 1974-1 CCH U.S.T.C. ¶ 9104 (D.C.W.D. Va. 1973), where one of the issues was whether a timely Subchapter S election had been made under section 1372. In 1967 the corporate charter had been issued, the corporation had received a loan, and property had been contributed; however, the corporation filed the election in July of 1968. The court held for the Commissioner finding that the corporate activity had begun in 1967 and the election should have been filed then. The shareholders were, therefore, denied loss deductions.

131. INT. REV. CODE of 1954, § 1372(e)(3).

not terminate if he consents to the election.¹³² A termination is effective for the tax year of the termination and all succeeding tax years.¹³³ The shareholders can unanimously elect to revoke an election after the first taxable year.¹³⁴ Unlike a termination, a revocation will be effective during the taxable year when made only if made during the first calendar month of such year, otherwise the revocation is valid only for succeeding tax years.¹³⁵ An election will also terminate if the corporation derives more than 80% of its gross receipts from foreign sources,¹³⁶ or if its passive investment income, such as royalties, dividends, interest, and rents, exceeds 20% of its gross receipts.¹³⁷ This passive investment income provision limits the use of the Subchapter S corporation to operating businesses as opposed to businesses engaged in the holding of rental property, for instance. There is an exception to the passive income provision for corporations engaged in a start up situation. The 20% rule does not apply to the "first taxable year in which the corporation commences the active conduct of any trade or business or the next succeeding taxable year" provided the amount of such passive investment income for each such year is less than \$3,000.¹³⁸

A Subchapter S corporation is a modified conduit through which, in general, the corporation's taxable income,¹³⁹ net operating loss,¹⁴⁰ certain long term capital gains,¹⁴¹ and certain credits, such as the investment credit,¹⁴² are passed to the shareholders. It is a modified conduit as opposed to a pure conduit for a variety of reasons. Tax-exempt income may be taxed to the shareholders on distribution because such income will increase the corporation's earnings and profits. Also, the taxable income will pass through only as ordinary income or in some cases long term capital gain, and loss will only pass through as a net operating loss. This should be contrasted with the pure conduit treatment for partnerships.

Section 1372(b)(1) provides that for any taxable year for which an election is in effect a Subchapter S corporation shall not be subject to the federal income tax, including the section 531 accumulated earnings tax and the section 541 personal holding company tax, except the tax imposed by section 1378 on certain long term capital gains in excess of \$25,000.¹⁴³ If the section 1378 tax attaches, the corporation, it may also be subject to the tax on tax preferences provided for in section 56. The section 1378 tax is of relatively little importance in the case of the operating corporation.

While section 1372(b)(1) exempts a Subchapter S corporation from tax, section 1372(b)(2) provides that for any taxable year of a shareholder in which or with which the taxable year of a Subchapter S corporation ends,

132. INT. REV. CODE of 1954, § 1372(e)(1); and Treas. Reg. § 1.1372-3(b) (1969).

133. INT. REV. CODE of 1954, § 1372(e)(1), (3), (4) and (5).

134. INT. REV. CODE of 1954, § 1372(e)(2).

135. INT. REV. CODE of 1954, § 1372(e)(2).

136. INT. REV. CODE of 1954, § 1372(e)(4).

137. INT. REV. CODE of 1954, § 1372(e)(5).

138. INT. REV. CODE of 1954, § 1372(e)(5).

139. INT. REV. CODE of 1954, § 1373.

140. INT. REV. CODE of 1954, § 1374.

141. INT. REV. CODE of 1954, § 1375(a).

142. INT. REV. CODE of 1954, § 48(e).

143. The section 1378 tax is designed to prevent the sale of a Subchapter S corporation's assets at a substantial capital gain with such gains being passed directly to the shareholders.

such shareholder shall account for the corporation's (1) taxable income in accordance with section 1373, (2) net operating loss in accordance with section 1374, and (3) certain special items, such as long term capital gains and distributions, in accordance with section 1375. The section further provides for certain basis adjustments to the shareholder's stock in accordance with section 1376. The effect of these provisions is to eliminate the double tax, except in the case of the section 1378 tax on certain capital gains.

Putting aside for the moment the case of cash or property distributions, section 1373(b) requires each shareholder to include in his gross income his proportionate share of the corporation's "undistributed taxable income," which "would have [been] received as a dividend" if there had been a pro rata distribution of such undistributed taxable income. A shareholder's proportionate share is determined by reference to his stock holdings. Since a Subchapter S corporation can only have one class of stock such determination is a simple matter; in fact, the regulations do not even deal with the question.

"Undistributed taxable income" is defined in section 1373(c) as the corporation's *taxable income*, minus (1) the taxes imposed, if any, on the long term capital gains by sections 1378 and 56, and (2) the amount of cash actually distributed which is a dividend out of the corporation's current earnings and profits. "Taxable income" is defined in 1373(d) to be normal taxable income without certain deductions such as the net operating loss deduction.

The reference in section 1373(b) to the amount which "would have [been] received as a dividend" calls for reference to the corporation's earnings and profits account.

In the case of a newly formed Subchapter S corporation which at all times has current earnings and profits equal to its undistributed taxable income, its accumulated earnings and profits account would always be zero and its current earnings and profits account would always be reduced to zero at the end of the corporation's tax year by reason of the pass through of the undistributed taxable income.

These principles can be illustrated as follows: Assume that A and B form the AB Subchapter S corporation, each acquiring 50% of the stock for an investment of \$100 K. If during the first year of operation the corporation had taxable income as defined in section 1373(d) in the amount of \$20K, which was equal to the corporation's current earnings and profits, and the corporation had made no cash distributions during the year and also was *not* subject to the section 1378 tax, then the following result would be obtained. The undistributed taxable income would be \$20K, and pursuant to section 1373(b) each of A and B would be required to include in his gross income \$10K of such undistributed taxable income.

In general, the character of a constructive dividend distribution of undistributed taxable income is ordinary income.¹⁴⁴ However, section 1375 (a) provides that in a case where a Subchapter S corporation has net long term capital gains which exceed net short term capital losses the character of a dividend in the hands of the shareholder shall be long term capital gain

144. INT. REV. CODE OF 1954, § 1377.

to the extent of the shareholder's proportionate share of such gain.¹⁴⁵

If a Subchapter S corporation has an operating loss deduction for a tax year such loss, pursuant to section 1374(b), shall be allowed as a deduction from the gross income of the shareholder to the extent of the shareholder's proportionate share of such loss.¹⁴⁶ A shareholder's proportionate share is determined by reference to such shareholder's stock holdings in the corporation on each day of the corporation's tax year. The character of such losses in the hands of the shareholders is a net operating loss. Capital losses can only be set off against capital gains and if the corporation has a net capital loss for a year such loss stays in the corporation is carried over to succeeding years pursuant to section 1212.

These principles can be illustrated as follows. Returning to the above hypothetical, if the AB Subchapter S corporation, had an operating loss of \$20K instead of a \$20K profit, pursuant to section 1374(a) each of A and B would have been allowed an operating loss deduction in the amount of \$10K.

As is the case of a partner, a shareholder of a Subchapter S corporation is required to take account of his proportionate share of the corporation's income items in his tax year with respect to which the corporation's tax year either co-terminates or ends within. Unlike section 706(b) of the partnership provision, there is no prohibition against a Subchapter S corporation electing a different tax year than its shareholders. Consequently, there may be a substantial period between the time the corporation earns income and the time the shareholder is required to include it in gross income.¹⁴⁷

The requirement that the shareholder of a Subchapter S corporation account for his share of the corporation's undistributed taxable income and net operating loss makes it necessary that the shareholder's investment be adjusted to reflect such accounting. A shareholder's investment is for tax purposes represented by the adjusted basis in the stock and indebtedness he owns in the corporation. Similar to the case of a partner, section 1376(a) requires that a shareholder's adjusted basis for his stock (but not his indebtedness) be increased by the amount of the undistributed taxable income the shareholder is required to include in his gross income pursuant to section 1373.¹⁴⁸ This increase in adjusted basis is made necessary by the fact that the investor has increased his investment in the firm by the amount of the constructive dividend which he was required to include in gross income. It is as though he had directly received the constructive dividend and then invested the money in the corporation. In the absence of a basis increase

145. This rule applies to both constructive dividends and actual dividends.

146. Section 1374(a) provides that the net operating loss of a Subchapter S corporation shall be allowed as a deduction from the gross income of the shareholders of such corporation. Section 1374(b) and (c) provides the rules for determining each shareholder's share of a corporation net operating loss. The allowable deduction is limited to the adjusted basis in the shareholder's stock and securities, see text accompanying notes 154-55, *infra*.

147. See text accompanying note 25, *supra*.

148. Section 1376(a) reads as follows:

The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

there would be a potential for double taxation of the gain, once when earned and again when the stock was sold or the corporation liquidated.

Also, similarly to the case of a partner, section 1376(b) requires that the basis of a shareholder's stock or indebtedness be reduced, but not below zero, by the shareholder's share of the corporation's net operating loss which he deducts pursuant to section 1374. Such adjustments are first applied to the stock until the basis is reduced to zero, then the adjustments are applied to the indebtedness.¹⁴⁹ Without such a basis adjustment there would be a potential double deduction for a net operating loss, once in the tax year of the loss and again when the stock was sold or the corporation liquidated.

Similarly to section 704(d) of the partnership provisions, section 1374(c)(2) limits the amount of operating loss which is allowable as a deduction to a shareholder to the amount of the adjusted basis of the shareholder's stock and debt in the corporation. Unlike section 704(d), however, there is no provision for holding non-allowable operating losses in a suspense account until the shareholder's basis in his stock or debt is increased. If a shareholder's basis is not sufficient to offset his share of a net operating loss then such loss vanishes.¹⁵⁰ There are no statutory provisions preventing a shareholder from increasing his investment either by loan or contribution to capital prior to the close of a loss year in order to increase the amount of deductible losses. However, such increased investments would have to be bona fide.

Unlike the case of a partnership, the liabilities of a Subchapter S corporation will not increase the basis of the stock owned by the shareholders. The conduit concept does not extend to corporate liabilities. Consequently, any increase in liabilities at the corporate level will not give rise to an increased potential for loss deductions by the shareholders.

In order to circumvent this limitation, a borrowing may be structured so that the shareholders are the actual borrowers followed by a contribution of borrowed funds to the corporation. In such case the adjusted basis of the shareholder's stock would increase in the amount of the cash contributed. However, in order for such a method to work the shareholder's borrowing must be a bona fide indebtedness of the shareholder.

There are numerous cases dealing with situations in which a shareholder has guaranteed a loan made to a Subchapter S corporation and claimed a basis increase in his stock. The cases are uniform, however, in holding that such a guarantee does not operate to increase the basis of the

149. It should be noted that if the basis of indebtedness is reduced by reason of a net operating loss it will never be increased by reason of the constructive distribution of undistributed taxable income. This leaves open the possibility of the redemption of the indebtedness at a price of only a capital gain tax to the shareholder because section 1232(a)(1) treats the retirement of corporate indebtedness as a capital transaction. Thus, the shareholder gets an ordinary loss deduction at the cost of only a capital gain or redemption, whereas a redemption of stock may generate ordinary income. See generally *Gamman v. Commissioner*, 46 TC 1 (1966), where the court noted the Commissioner's concern for this disparity and indicated that this is one of the reasons the Commissioner has taken the position that indebtedness is a second class of stock thereby disqualifying the corporation from Subchapter S treatment. Note, however, that the inequity would only be exaggerated if the basis of the debt were increased because then there would be a mere return of capital to the extent of adjusted basis on redemption.

150. INT. REV. CODE OF 1954, § 172(h).

shareholder's stock. Such a situation was presented in *Peter E. Blum*¹⁵¹ where the taxpayer had guaranteed loans made to his corporation. He claimed that the guarantee operated to increase the basis of his stock, and, thereby, increase the amount of his allowable net operating loss deduction. The Commission disallowed the deduction, and the taxpayer challenged the Commissioner's determination on the following alternative grounds:

[T]he loans guaranteed by him which were made to the corporation by third parties were either indebtedness of the corporation to him or *in substance loans to him by the third parties, followed by his capital contribution to the corporation.*¹⁵² (emphasis added)

In summarily rejecting the taxpayer's first point the court quoted as follows from its decision in *Milton Raynor*:¹⁵³

"No form of indirect borrowing, be it guaranty, surety, accomodation, or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation. Prior to that act, liability may exist, but not debt to the shareholders. . ."¹⁵⁴

The court further said that "[i]n the absence of a showing that the debt . . . runs 'directly to the shareholder' we must reject [the taxpayer's] first contention."¹⁵⁵

On the taxpayer's second point the Court hedged, reasoning that in certain cases a shareholder's guarantee of loans made to a thinly capitalized corporation may be contributions of capital by the shareholder if the shareholder is in substance the principal obligor. The Court held, however, that the taxpayer here did not meet his burden of proof on such question. Further, the court pointed out that there are apparently no cases in which such third party loans have been classified as equity for purposes of increasing the basis of stock in a Subchapter S corporation. *Blum* may be read to stand for the proposition that if the taxpayer meets his burden of proof that a guaranteed borrowing is in effect equity, such borrowing will be considered a capital contribution.

2. *Current Cash and Property Distributions by Subchapter S Corporations*

As indicated above a Subchapter S corporation is, except where otherwise expressly provided in Subchapter S, subject to the provisions of Subchapter C. In the case of a current cash or property distribution by a Subchapter S corporation the rules of Subchapter S and C intersect.

A distribution of cash, as opposed to a distribution of property, out of a Subchapter S corporation's current earnings and profits will reduce the undistributed taxable income.¹⁵⁶ This result is mandated by section 1373(c) which defines undistributed taxable income to mean:

151. 59 T.C. 436 (1973).

152. *Id.* at 438.

153. 50 TC 762 (1968).

154. *Blum* at 438.

155. *Id.*

156. There is one exception to this rule. Section 1375(f) provides that cash distributions within 2½ months of the close of a Subchapter S corporation's tax year will not be out of current earnings and profits. See text accompanying notes 159, *infra*.

Taxable income . . . minus the sum of (1) the taxes imposed by sections 56 and 1378(a) and (2) the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of [current] earnings and profits . . . as specified in section 316(a)(2).

The question of whether a cash distribution is out of current earnings and profits must be resolved by reference to the rules of Subchapter C governing property distributions. Consequently, if a cash distribution would be out of current earnings and profits of a Subchapter C corporation, it will also be out of current earnings and profits of a Subchapter S corporation.¹⁵⁷

As actual cash distributions out of current earnings and profits increase, the constructive distribution of undistributed taxable income will decrease. If such actual cash distributions are equal to the corporation's taxable income there will be no constructive distribution because the corporation will have zero undistributed taxable income. It should be emphasized that the current earnings and profits of a Subchapter S corporation need not be equal to taxable income; for example, a Subchapter S corporation may have tax-exempt income which will cause its current earnings and profits to exceed taxable income. Consequently, a cash distribution in excess of taxable income will produce a dividend out of current earnings and profits to the extent such earnings and profits exceed taxable income. Further, cash distributions in excess of current earnings and profits may produce a dividend if there are accumulated earnings and profits in the corporation.¹⁵⁸

These principles can be illustrated as follows. Assume that the AB 50-50 Subchapter S corporation has both taxable income and current earnings and profits of \$50K. Assume further, that during the current tax year the corporation made a cash distribution to each of A and B in the amount of \$20K. In such case the \$20K would be a dividend out of current earnings and profits as determined by the rules of Subchapter C. Moreover, by reason of section 1373(c) the corporation's undistributed taxable income would be equal to \$10K (the taxable income \$50K minus the \$40K cash distributed out of current earnings and profits). Consequently, pursuant to section 1373(a) each of A and B would be required to include in his gross income \$5K of such undistributed taxable income. Each receives a \$20K actual dividend distribution of cash and a \$5K constructive dividend distribution of undistributed taxable income. Only the constructive distribution would generate an increase in the adjusted basis of their stock pursuant to section 1376(a).

The shareholders of a Subchapter S corporation might want to receive actual money distributions in the exact amount of the corporation's taxable income. They may want to have the money available to pay the taxes that will be owed in respect of such taxable income. It is often times difficult, however, to precisely measure a corporation's taxable income as of the last day of the corporation's tax year. Therefore, it would generally be very difficult for a Subchapter S corporation to make an actual distribution of cash equal to the exact amount of the taxable income before the close of the cor-

157. INT. REV. CODE of 1954, §§ 301(c)(1) and 316(a).

158. Such excess cash distributions may be given nondividend treatment by section 1375(d). See text accompanying note 162, *infra*.

poration's tax year. In order to make such actual distributions possible, section 1375(f) provides an exception to the general rule of Subchapter C that actual distributions of cash out of current earnings and profits will be taxable dividends. Such section treats distributions of cash during the first 2½ months after the close of a Subchapter S corporation's tax year as distributions of the corporation's undistributed taxable income for such prior tax year, but only to the extent of each shareholder's share of such undistributed taxable income.¹⁵⁹

As distributions of the prior year's undistributed taxable income such cash is not out of current or accumulated earnings and profits but is a mere return of capital. As a return of capital, the cash will generate a basis reduction in the shareholder's stock pursuant to the rules of Subchapter C. It should be noted that the preferred treatment of section 1375(f) is limited to cash (money) distributions and not property distributions. The benefit of section 1375(f) is personal to the shareholder and cannot be transferred.¹⁶⁰

Any cash distributed during such 2½ month period which is in excess of a shareholder's share of the prior year's undistributed taxable income will be first treated as distributions out of the corporation's current earnings and profits to the extent thereof.¹⁶¹

The treatment of actual cash distributions discussed above are on two levels. First, distributions within 2½ months after the close of the tax year will be treated as distributions of undistributed taxable income of the closed tax year to the extent thereof. Second, distributions within such 2½ month period in excess of such undistributed taxable income plus distributions after such 2½ month period will be considered distributions out of the corporation's current earnings and profits to the extent thereof.

The next logical question is what if the cash distributions are in excess of the first and second levels? As noted in the discussion of the general scheme for taxing corporations, if a regular corporation makes a distribution

159. Of course, section 1373(f)(1) requires that the corporation have been a Subchapter S corporation for the prior year; there is no requirement, however, that it be so for the year of distribution. Further, the section requires that the distribution have been made to a person who was a shareholder at the close of the prior tax year. Distributions during the 2½ month period are cumulated to determine when the distributions in the aggregate equal the amount of a shareholder's share of the undistributed taxable income for the prior tax year. Since such distributions are not dividends there is no effect on the corporation's earnings and profits account. Section 1375(f)(1) provides:

Any distribution so treated shall, for purposes of this chapter, be considered a distribution which is not a dividend, and the earnings and profits of the corporation shall not be reduced by reason of such distribution.

Pursuant to section 1375(f)(2) a shareholder's share of undistributed taxable income is the amount of such income which the shareholder was required by section 1373(b) to include in his gross income in the prior year.

160. Treas. Reg. § 1.1375-6(a)(4) (1968) makes this nontransferability crystal clear:

A person's right to nondividend distributions under this section is personal and cannot in any manner be transferred to another. If a shareholder transfers part or all of his stock in a corporation, his share of undistributed taxable income is not reduced by reason of the transfer, and the transferee does not acquire any part of such share. However, in such a case the transferor's total basis for his stock in the corporation is reduced by the amount of his basis for the stock transferred. A distribution of undistributed taxable income in excess of the transferor's remaining basis is subject to the provisions of section 301(c)(3).

161. INT. REV. CODE of 1954, § 1373(c).

in excess of current earnings and profits, such distribution will be deemed to be out of accumulated earnings and profits to the extent thereof. Section 1375(d)(1), however, provides an exception to this general rule for cash distributions which would normally be out of accumulated earnings and profits. Cash distributions shall be treated as nontaxable distributions to the extent they are out of a shareholder's net share of the corporation's undistributed taxable income which was taxed in prior tax years but never distributed.¹⁶² Such income is referred to as previously taxed income. The "never distributed" concept refers, in general, to the undistributed taxable income of prior years which was not deemed distributed pursuant to either the 2½ month rule of section 1375(f) or the excess cash distribution rule of section 1375(d)(1).¹⁶³

As is the case of a shareholder's share of a closed year's undistributed taxable income, a shareholder's net share of previously taxed income is also personal to him and cannot in any manner be transferred to another.¹⁶⁴

Treas. Reg. § 1.1375-4(b) makes it crystal clear that a distribution of previously taxed income can occur only during a tax year when the cash distributions are in excess of the corporation's current earnings and profits. In such case the presence of previously taxed income will short circuit a distribution from being treated as out of accumulated earnings and profits and cause it to be a nontaxable return of capital.

Section 1375(f) and (d) nontaxable dividend distributions require a basis adjustment to the shareholder's stock. They are considered actual distributions of income which were previously taxed by reason of the constructive distribution rule of section 1373(b). Since the constructive distribu-

162. Section 1375(d)(1) gives the Secretary of Treasury the authority to promulgate regulations under which a Subchapter S corporation can distribute to:

any shareholder all or any portion of the shareholders' net share of the corporation's undistributed taxable income for tax years prior to the taxable year in which such distribution is made . . . [which] distribution shall . . . be considered a distribution which is not a dividend, [and] the earnings and profits shall not be reduced by reason of such distribution.

The statute does not require that distributions which qualify for the preferred treatment of section 1375(d)(1) be made in "money" as is the case with (1) section 1375(f) 2½ month distributions, and (2) the offset allowed by section 1373(c) of money distributions out of current earnings and profits against a corporation's undistributed taxable income. However, Treas. Reg. § 1.1375-4(b) (1968) specifically provides that only money distributions can qualify for section 1375 treatment, and the regulation was held valid in *U.S. v. Detreville*, 445 F.2d 1306 (4th Cir. 1971) (holding that (1) the distributions of checks followed by an exchange of the checks for stock in a subsidiary was in essence a distribution of property, and (2) since the distributions was of property it could not qualify for the section 1375(d) treatment because Treas. Reg. § 1.1375-4(b) (1968) is valid; reasoning that the regulation brings 1375(d) into harmony with section 1373(c).)

A shareholder's net share previously taxed undistributed taxable income is defined in section 1375(d)(2) as the amount of undistributed taxable income such shareholder included in his gross income for all prior tax years, minus the sum of (1) the net operating loss deductions allowed to such shareholder, and (2) the previous distributions to such shareholder during both the current and prior tax years which were not dividends by reason of qualifying as either section 1375(f) 2½ month distributions or section 1375(d) distributions of previously taxed income.

163. See second paragraph of note 162, *supra*.

164. Treas. Reg. § 1.1375-4(e) (1968) is substantially the same as Treas. Reg. § 1.1375-6(a)(4) (1968), quoted in note 160, *supra*, with the additional provision that a shareholder who sells and then repurchases his stock will reacquire his previously taxed income account.

tions required an increase in basis under section 1376(a), it is logical that a subsequent actual distribution, which is considered as being part of the amount previously constructively distributed, should require a basis reduction. Nothing in Subchapter S provides for such an adjustment. However, as was emphasized at the outset of this discussion all Subchapter S corporations are subject to the rules of Subchapter C unless otherwise specifically provided. Since nothing in Subchapter S requires a basis adjustment for such distributions, Subchapter C applies, and the following results with respect to such distribution would obtain. Pursuant to section 301(c)(2) distributions which are not dividends are applied against and reduce the basis of the shareholder's stock. If the distribution is in excess of the shareholder's adjusted basis, section 301(c)(3) requires that such excess be treated as gain from the sale or exchange of such stock.¹⁶⁵

The treatment of current cash distributions of a Subchapter S corporation can be summarized by reference to the following six levels of distribution:

First Level Cash distributions within 2½ months of the close of the corporation's tax year shall be considered as nontaxable distributions of the undistributed taxable income of the closed year to the extent thereof.¹⁶⁶

Second Level Cash distributions with 2½ months of the close of the corporation's tax year which are in excess of the first level plus all other cash distributions during the year shall be considered as out of the corporation's current earnings and profits to the extent thereof.¹⁶⁷

Third Level Cash distributions in excess of the second level shall be treated as nontaxable distributions out of the corporation's previously taxed income to the extent thereof.¹⁶⁸

Fourth Level Cash distributions in excess of the third level shall be treated as out of accumulated earnings and profits to the extent thereof.¹⁶⁹

Fifth Level Distributions in excess of the fourth level shall be applied against and reduce the adjusted basis of the shareholder's stock but not below zero.¹⁷⁰

Sixth Level Distributions in excess of the fifth level shall be treated as gain from the sale of the stock which in most cases will be long term capital gain.¹⁷¹

The next logical question is how are property distributions of a Subchapter S corporation treated? The answer to this question must be culled out of Treas. Reg. §§ 1-1373-1(d), (e), and (g) (examples (3) and (4)). The rules set out in these regulations can be summarized by reference to five levels of distribution:

165. See text accompanying notes 86, 162, *supra*.

166. INT. REV. CODE of 1954, § 1375(f). Such distributions will cause a reduction in the adjusted basis of the stock pursuant to section 301(c)(2).

167. INT. REV. CODE of 1954, §§ 1373(c) and 301(c)(1).

168. INT. REV. CODE of 1954, § 1375(d). Such distribution will cause a reduction in the adjusted basis of the stock pursuant to section 301(c)(2).

169. INT. REV. CODE of 1954, § 301(c)(1).

170. INT. REV. CODE of 1954, § 301(c)(2).

171. INT. REV. CODE of 1954, § 301(c)(3).

First Level Property distributions can be considered as out of current earnings and profits only in a case where the cash distributions do not completely exhaust the current earnings and profits.

Second Level If the cash distributions do not exhaust the current earnings and profits, then the remaining current earnings and profits shall be allocated ratably to (1) the constructive distribution of undistributed taxable income, and (2) the actual distributions of property taken at a fair market value. Since pursuant to section 1373(b) only that part of the undistributed taxable income which would have been a dividend is includible in a shareholder's gross income, such portion which is a dividend by reason of current earnings and profits will be dependent on the amount of current earnings and profits allocated to it.

Third Level If the current earnings and profits are exhausted by cash distributions or any combination of cash distributions, property distributions, and constructive distribution of undistributed taxable income then any excess distributions of property shall be deemed to be ratably out of accumulated earnings and profits to the extent thereof.

Fourth Level Any property distributions in excess of the third level shall be treated as a return of capital to the extent of the shareholder's adjusted basis in his stock.

Fifth Level Any property distributed in excess of the fourth level shall be treated as gain from the sale or exchange of stock.

IV. COMPARATIVE ANALYSIS OF THE FORMS

The question of which form will minimize the federal income tax liability will be dependent on numerous variables. Some of the principal variables include: (1) the liquidity needs of the investor, (2) the tax bracket of the investor, (3) whether the firm is expected to generate profits or losses in a given tax year, (4) the adjusted basis of the ownership interest, and (5) whether the firm will be incurring liabilities. A change in one variable may produce a substantial change in tax result; consequently, each situation must be analyzed on its own merit in order to determine if the tax results which would be produced by the three forms diverge or converge.

In order to help facilitate an appreciation of the potential tax stakes of operating in the three forms the tax impact on the firm and investors for the first year of a firm's existence will be compared under the following assumptions:

- (1) The firm will be owned equally by A and B, both of whom are employees of the firm.
- (2) A has \$10K of taxable income from sources other than the firm. B has \$50K of taxable income from such sources.
- (3) A's adjusted basis for his ownership interest, whether stock or partnership interest, will be \$100K, because he will contribute \$100K in cash to the firm. B's adjusted basis will be \$10K because he will contribute an asset with a fair market value of \$100K with an adjusted basis of \$10K.
- (4) Each investor will draw a salary of \$25,000 a year.
- (5) The firm will not make any distributions.
- (6) During the first year of operation, the firm can be expected to operate at a \$100K operating loss after deducting the employees salaries.

The following matrix summarizes the above information:

Investor	Outside Taxable Income	Adjusted Basis Ownership Interest	Salary	Share of Operating Loss After Deducting Owner's Salaries
A	\$10K	\$100K	\$25K	(\$50K) loss
B	\$50K	\$10K	\$25K	(\$50K) loss

Given the above data the following results would obtain under the three forms.

1. *Partnership Form*

Each of A and B would include his \$25K salary in gross income. Each would have a \$50K distributive share of the partnership losses which would be an allowable deduction to the extent of the adjusted basis of his partnership interest. A would get a full \$50K deduction and the adjusted basis of his partnership interest would be reduced from \$100K to \$50K. The \$50K deduction would completely offset his \$25K salary and his \$10K outside taxable income. The \$15K excess deduction would be a net operating loss which he could carryback three years and forward five years.

B's allowable deduction would be only \$10K and his adjusted basis would be reduced from \$10K to zero. The \$10K deduction would only offset \$10K of his \$25K salary; consequently, the net effect on him for the year from the partnership would be income of \$15K. The \$40K non-deductible portion of B's loss would be put in a suspense account and would be an allowable deduction in future years if the adjusted basis of his partnership interest is increased.

If the partnership had incurred liabilities during the year, such as bank loans, each of A's and B's basis would have been increased and B would have been able to deduct a greater amount of his distributive share of the loss.

If the salaries had been structured as distributions, the partnership loss would have been \$50K. A's basis would have been reduced from \$100K to \$75K by reason of the \$25K distribution and from \$75K to \$50K by reason of the pass through of his \$25K distributive share of the loss. B's basis would have been reduced from \$10K to zero, and he would have had a \$15K capital gain because the distribution would exceed the adjusted basis of his partnership interest in that amount. B's share of the operating loss would be put in a suspense account.

2. *The Subchapter C Form*

Each of A and B would include his \$25K salary in gross income. The \$100K loss would not pass through, consequently these salaries would be fully included in income. The loss to the corporation would be a net operating loss and as such could be carried forward for five years; since the corporation would be newly organized, it could not be carried back three years. At the end of the first year the corporation would have an accumulated deficit in earnings and profits of \$100K.

If the salaries had been structured as dividends, the corporation's operating loss would have been \$50K, and each of A and B would have received a non-taxable return of capital to the extent of the adjusted basis of his stock. A's basis would have been reduced from \$100K to \$75K, and he would have a full non-taxable return of capital. B's basis would be reduced from \$10K to zero and he would have a capital gain of \$15K, the amount by which the distribution would exceed his adjusted basis.

3. *The Subchapter S Form*

Each of A and B would include his \$25K salary in gross income. Each would have a \$50K share of the corporation's net operating loss. A would be allowed a deduction of \$50K which would completely offset his salary and outside taxable income and the \$15K excess deduction would be a net operating loss carryback and carryover. The adjusted basis for his stock would be reduced from \$100K to \$50K.

B's portion of the loss would be allowed as a deduction only to the extent of the \$10K basis in his stock; the \$40,000 excess would *vanish* and be of no tax benefit to anyone. The basis of B's stock at the end of the year would be zero. The net effect of the first year's operations on B would be a \$15K increase in gross income. The corporation would have a zero accumulated earnings and profits at the end of the year.

If the Subchapter S corporation had incurred liabilities during the year there would not have been any change in the tax results, because liabilities incurred by such corporations do not generate an increase in the basis of the shareholder's stock. Consequently, B would not have been able to deduct any more of his share of the net operating loss.

If the salaries had been structured as distributions, the net operating loss would have been \$50K. The distribution would have been taxable as a return of capital to the extent of the adjusted basis of each of A's and B's stock. The full \$25K would have been a return of capital to A, and he would have reduced the basis in his stock to \$75,000. Further, his \$25,000 share of the net operating loss would have been allowed as a deduction and his basis would have been reduced to \$50K. Only \$10K of B's \$25K distribution would have been a return of capital, the \$15,000 balance would have been a capital gain. Further he would not get to deduct any of his portion of the \$25K loss and it would vanish.

4. *Comparative Analysis*

The most desirable tax treatment for A would occur in either the partnership or Subchapter S forms. Under each he could get a full deduction for his share of the operating loss. For B the most desirable appears to be the partnership form because the nondeductible share of his loss would go into a suspense account, whereas it would vanish if the form is a Subchapter S corporation. Also, if the partnership incurs liabilities during the year the portion of his share of the loss which would be allowable as a deduction would increase. This is not the case for the Subchapter S corporation.

Other things being equal, A would be indifferent between having the salary restructured as a distribution in either the case of a partnership or Sub-

chapter S corporation, because in any event his basis would be reduced to \$50K and he would have a \$25K loss to offset his outside income. B would be better off, however, having the salary restructured as a distribution if the form is a partnership or Subchapter S corporation because he would convert what would otherwise be \$15K of ordinary income into a \$15K capital gain.

If the Subchapter C form were chosen there would be a whopping tax on the \$25K salary each of A and B would receive, and if the corporation did not make a profit in the next five years there would be no tax benefit to anyone in respect of the corporation's deduction for such salaries. It would be advantageous to both A and B to restructure the salaries as distributions.

As a general rule in a start-up situation where the firm is going to generate losses initially, the most desirable form would be either a partnership or Subchapter S corporation. As the firm becomes profitable, however, it may become desirable to switch to a Subchapter C corporation in order to shield income from the higher individual tax rates. The question of whether and when to switch, would be a function of numerous variables one of which would be the possibility that the accumulated earnings tax would attach.