ABSTRACT

AN INQUIRY INTO THE DESIRABILITY AND FEASIBILITY OF MANDATORY PARTNERSHIP TAX TREATMENT FOR CLOSELY HELD CORPORATIONS

by

Glen Raymond Sanderson

This study was undertaken to determine the desirability and feasibility of applying the partnership method of taxing business income to closely held corporations on a mandatory basis. This system, if adopted, would replace the regular corporate income tax system, as applied to closely held corporations, and Subchapter S of the Internal Revenue Code, the subchapter which gives certain closely held corporations the option to be taxed somewhat like partnerships.

The specific objectives of the study were: (1) to examine the need for changing the existing system of taxing closely held corporations, (2) to determine the extent to which mandatory application of the partnership tax method would correct the deficiencies of the existing system, and (3) to examine the major problems and issues involved in designing and implementing the mandatory partnership system.

In examining both the existing system of taxing closely held corporations and the proposed mandatory partnership tax

system, consideration was given to equity, administrative and compliance factors, and economic consequences. In addition, the constitutionality of the mandatory partnership approach was considered.

The circumstances which prompted this study were: (1) apparent major inequities and administrative and compliance problems associated with applying the corporate tax method to closely held corporations; (2) the apparent failure of Subchapter S to mitigate these problems to a significant extent; (3) problems peculiar to Subchapter S; and (4) the lack of serious consideration given to the mandatory partnership approach.

The analysis and conclusions contained in the study are based on an examination of basic sources of tax law; studies dealing with various aspects of federal income taxation and related areas; and statistical data compiled by the Internal Revenue Service, the Securities and Exchange Commission, and other organizations.

Principal findings: The mandatory partnership approach clearly would provide a more equitable means of taxing the income of closely held corporations than that provided by the existing system of taxing closely held corporations, in terms of both horizontal equity and ability to pay.

Most of the uncertainty and arbitrariness in tax

determinations associated with the existing system--in areas such as unreasonable compensation, accumulated earnings, and loss of the Subchapter S election--could be eliminated by the adoption of the mandatory partnership system. However, other administrative and compliance problems would be added by the mandatory system, including those associated with selecting corporations to be included in the mandatory system, applying the partnership tax method to closely held corporations with multiple classes of stock, and making the transition from the existing system.

Although the economic effects of adopting the mandatory partnership system are uncertain, the most probable effects appear to be the following: (1) less than a two percent change in total income tax receipts; (2) a slight net disincentive to form, work hard in, and expand small corporations owned by individuals in upper-middle and high personal tax brackets; (3) a significant reduction in the funds available after taxes to finance the growth of some small corporations; and (4) elimination of the incentive to hoard funds in closely held corporations for tax purposes.

Legal precedents and opinion are divided with respect to the constitutionality of mandatory partnership tax treatment for domestic closely held corporations. However, it does appear that the mandatory partnership system could be

adopted without a constitutional amendment.

As a whole, the mandatory partnership system appears to be no less desirable nor feasible than the existing system. Certainly there are no obvious reasons for rejecting the mandatory partnership approach without further research.

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By

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Glen R. Sanderson

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CHAPTER I

INTRODUCTION

Purpose of the Study

Representative Mills, Chairman of the House Ways and Means Committee, has stated that one of the essential factors to be considered in any re-evaluation of the federal tax structure is its fairness between taxpayers, and that in pursuing this objective, tax laws "must accord the same tax treatment to what is essentially the same type of operation irrespective of the form in which it is cast."[1]

One of the most flagrant violations of the above principle is that which can be found in the tax treatment accorded closely held corporations, as compared with the tax treatment accorded unincorporated business enterprises. Depending upon a number of factors--including the nature of business operations, individual tax brackets of shareholders,

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[1]Excerpt from a speech delivered to the Tax Foundation (December, 1958), referred to in: U. S. House, Tax Revision Compendium, papers submitted to the Committee on Ways and Means (Washington, D. C.: Government Printing Office, 1959), Vol. III, p. 1700.

and how and when corporate income is distributed--the tax burden of shareholders of a given closely held corporation may be significantly higher or lower than it would be if the same operations were taxed under an unincorporated legal form.

This study is an attempt to determine the desirability and feasibility of adopting one approach to removing the major differences between the tax treatment accorded closely held corporations and unincorporated business enterprises. In the approach to be considered, the partnership method of taxing business income is applied to closely held corporations on a mandatory basis. This system, if adopted, would replace (1) the regular corporate income tax system, as applied to closely held corporations, and (2) Subchapter S of the Internal Revenue Code, the subchapter which gives certain closely held corporations the option to be taxed somewhat like partnerships.

The specific objectives of this study are: (1) to examine the need for changing the existing system of taxing closely held corporations, (2) to determine the extent to which mandatory application of the partnership tax method would correct the deficiencies of the existing system, and (3) to examine the major problems and issues involved in designing and implementing the partnership system.

In examining both the existing system of taxing closely held corporations and the proposed mandatory

partnership tax system, consideration is given to equity, administrative and compliance factors, and economic consequences. In addition, the issue of the constitutionality of mandatory partnership tax treatment is examined. These criteria and the tax methods mentioned above are explained in this chapter.

The circumstances which prompted this study are: (1) the lack of serious consideration given to the mandatory requirement of the partnership approach and (2) the failure of Subchapter R, which gave certain proprietorships and partnerships the option to be taxed like corporations, and Subchapter S to make a substantial contribution to the removal of inequities and certain administrative and compliance problems associated with the taxation of closely held business enterprises.

Background

The Corporate Population

Business corporations are most heterogeneous as to financial size, nature of business activities, number of shareholders, and extent of separation of ownership and control. Nevertheless, except for a small percentage of corporations, the entire range of corporations may be split into two basic groups: widely held (public) corporations and closely held (private) corporations. Corporations

which have numerous shareholders, but which are closely controlled by a few shareholders, comprise the small percentage that does not fall neatly into either of the two basic groups.

Widely held (public) corporations. The most distinctive feature of publicly held corporations is the separation of ownership and control. The typical large, publicly held corporation is a separate economic entity, as well as a separate legal entity. Corporate attributes such as limitation of ownership liability, marketability of ownership interests, representative management, and continuity of organization life are all substantive aspects of this mode of organization.

Although relatively few in number, publicly held corporations account for the bulk of corporate income and tax payments in the United States. In 1964, 5,886 corporations had assets in excess of $25 million--less than one-half of 1 percent of business corporations.[2] This group, which includes substantially all of the major publicly held corporations in the United States (parents and subsidiaries), reported 71 percent of total corporate net income and paid 70 percent of the total corporate income tax collected in

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[2]U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1964, Corporation Income Tax Returns (Preliminary) with accounting periods ended July 1964-June 1965 (Washington, D. C.: Government Printing Office, 1967), p. 30.

1964.[3] In recent years, the stock of less than 2 percent of business corporations has been listed on a national or regional stock exchange or traded actively over-the-counter (see Chapter VI).

Closely held (private) corporations. The most important characteristic of private corporations is the unity of ownership and control. The labels--shareholders, officers, and directors--as used in the typical private corporation cover essentially the same content: the interests of one or a few key shareholders who are the principal owners and controllers of the corporation. Private corporations are essentially proprietorships or partnerships clothed in the legal form of a corporation.

The dominant reason many owners of private corporations choose the corporate form of organization is to reduce their tax burden. Of secondary importance is the feature of limited liability if the business fails. However, even the advantage of limited liability is restricted in that banks and other creditors frequently require the principals of these corporations to guarantee personally the repayment of major loans. The feature of unrestricted transferability of ownership interests is also of limited value to these corporations--only a small percentage of private corporations

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[3] Ibid.

are ever in a position to issue stock successfully to the public (see Chapter VI).

Although smallness in financial size is not an essential feature of closely held (private) corporations, this characteristic usually follows from other characteristics. In 1964, 1,373,517 business corporations filed tax returns; of which, 94 percent had assets totaling less than $1 million.[4] Based on statistics and estimates presented in Chapter VI of this study, only a small percentage of corporations with assets of less than $1 million have more than 25 shareholders; the vast majority has less than 10.

The problems involved in classifying corporations according to number of shareholders, control, and financial size for purposes of determining which corporations would be included in the mandatory partnership tax system are examined in Chapter VI. A shareholder limit of 25 and an asset limit of $1 million provide two general guidelines for delineating the principal group of corporations with which this study deals. More than 95 percent of business corporations would be included in the mandatory partnership tax system considered in this study.

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[4] Ibid.

Federal Income Taxation: An Overview

Business income taxation. Two general methods of taxing the income earned in connection with a business enterprise have dominated federal income tax laws since 1913: the corporate method and the individual method. Under the corporate method, the income of corporations is taxed at corporate rates and dividend distributions of income are taxed again as part of the personal income of shareholders. Under the individual method, on the other hand, proprietorships and partnerships are not taxed as business entities; rather, the entire income of these enterprises, whether distributed or not, is allocated to the owners to be taxed as part of their personal income.

For purposes of this study, the only significant exceptions to this dichotomous system have been Subchapter R and Subchapter S of the Internal Revenue Code. Subchapter R, which gave certain proprietorships and partnerships the option to be taxed like corporations was enacted in 1954. This provision was repealed in 1966 (to terminate in 1969), principally because it had been used by very few unincorporated business enterprises.[5] Subchapter S, which gives certain closely held corporations the option to be taxed

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[5]U. S. Senate, Committee on Finance, Subchapters S and R of Chapter 1 of the Internal Revenue Code of 1954, S. Rept. 1007, 89th Cong., 2nd Sess., 1966, p. 9.

somewhat like partnerships, was enacted in 1958. In 1964, Subchapter S was used by 12 percent of all business corporations; the percentage using Subchapter S has been increasing slightly.[6] The main objective in enacting these provisions was to permit owners of small businesses to select a legal form of organization without having to be unduly concerned about the tax consequences of the selection.[7] These provisions are examined in Chapter IV.

The corporate income tax. The modern series of corporate income tax laws began with the Corporate Excise Tax Act of 1909, which imposed a tax of 1 percent on the net income of corporations for the privilege of doing business under the corporate form.[8] This income tax was enacted under the guise of an excise tax to avoid the Supreme Court decision which ruled the Revenue Act of 1894 (the first major federal income tax law) was unconstitutional.[9]

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[6]Statistics of Income, 1964, Corporation Income Tax Returns (Preliminary), op. cit., p. 41.

[7]U. S. Senate, Committee on Finance, Technical Amendments Act of 1958, S. Rept. 1983, 85th Cong., 2nd Sess., C.B., 1958-3, p. 1008

[8]Act of 1909, 36 Stat. 11.

[9]Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 3 AFTR 2602 (1895). The constitutional problem is examined in Chapter V. Federal income taxes were collected during the Civil War; however, the Civil War tax acts have little, if any, relevance to modern income taxation.

Following adoption of the Sixteenth Amendment to the Constitution, the Corporation Excise Tax Act of 1909 was superseded by the Revenue Act of 1913. The latter act provided for a tax on both corporate income and individual income, including income from unincorporated business enterprises. Under the 1913 act, a 1-percent normal (base) tax was imposed on corporate income and on personal income; in addition, personal income was subject to graduated rates up to 7 percent.[10]

Numerous revisions of corporate income tax laws have been enacted since 1913. The top corporate tax rate reached 12 percent during World War I, 40 percent during World War II, and 52 percent during the Korean War. Current corporate tax rates (1967) are 22 percent of the first $25,000 of taxable income and 48 percent thereafter. Corporate tax rates have been graduated mildly since 1936 as a concession to small business. In addition to the regular corporate income tax, a tax on undistributed corporate profits was imposed in 1936. This tax, which was intended to force corporations to distribute more of their income as dividends to be taxed at rates applicable to individuals, was repealed in 1938, after it had been vigorously criticized as a deterrent to corporate growth. Also, the regular corporate income tax was

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[10]Act of 1913, 38 Stat. 114.

supplemented by an excess profits tax during World War I, World War II, and the Korean War.[11]

Relief from double taxation of dividends. Provisions designed to provide some relief from double taxation of corporate income distributed as dividends to individuals have been in and out of the tax laws since 1913. Prior to 1936, dividends were excluded from the individual normal tax, but not the surtax (which was the progressive element of the tax). From 1936 to 1954, dividends were fully taxable as personal income. From 1954 to 1964, the first $50 of dividends ($100 for joint returns) could be excluded from the individual income tax and 4 percent of taxable dividends received could be offset against the individual tax. Under the current law (1967) the first $100 of dividends ($200 for joint returns) may be excluded from the individual tax. These provisions are examined in Chapter II. Corporations (as shareholders) are, in general, permitted to deduct from gross income 85 percent of dividends received from domestic corporations.[12]

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[11] U. S. Congress, Joint Economic Committee, The Federal Tax System: Facts and Problems 1964, 88th Cong., 2nd Sess., 1964, pp. 49, 61-63, 265.

[12] Ibid., pp. 45, 59. Certain affiliated groups of corporations which either do not, or cannot, file consolidated tax returns may elect a 100-percent dividend received deduction for intercompany dividends. I.R.C. (1954), sec. 243 (b).

The individual income tax. The individual income tax system also has been revised numerous times since its inception in 1913. Among the principal and most durable general features of this system are the following: (1) taxation of personal income at progressive rates; (2) allowed deductions for certain personal expenses, such as interest and state sales taxes, or in lieu of these deductions, an optional standard deduction (first in 1944, two kinds of standard deductions are now available); and (3) exemption of various amounts of income from the individual income tax for personal circumstances, most notably exemptions for the taxpayer, his spouse, and dependents. Other major developments include (1) income splitting for married couples (since 1948, before 1948, splitting was contingent upon whether or not the taxpayer resided in a state with community property laws) and (2) income averaging to avoid excessive taxation at progressive rates of bunched income (since 1964).[13]

Criteria and Problems

This section describes the criteria used in evaluating the federal income tax system and applies these criteria to the taxation of closely held corporations for the purpose of pointing out the major issues and problems that are examined

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[13] The Federal Tax System: Facts and Problems 1964, op. cit., pp. 19-26, 233.

in this study. The viewpoint taken in this study is one of public policy. An attempt is made to give a balance emphasis to various criteria in examining both the existing system of taxing closely held corporations and the mandatory partnership tax system.

Equity in Taxation

Based on the proposition that individuals (natural persons) ultimately receive all the income generated in the economy and bear all the taxes, equity, in the strict sense, deals principally with individuals. Determination of equity (or fairness) in the distribution of tax burden is based largely on the value judgments of society. Although there are no scientific or highly objective standards of equity, a few rough guidelines have been established. Among these are the principles of horizontal and vertical equity. Horizontal equity requires that persons in similar circumstances be accorded similar tax treatment. Vertical equity requires that persons in different circumstances be accorded fair relative tax treatment. Vertical equity deals mainly with progressivity in taxation.

Two general approaches to appraising an individual's circumstances for purposes of distributing tax burden in an equitable manner have dominated the field of public finance for over fifty years: benefits received from the government and ability to pay.

Taxation based on benefits received involves viewing the government as a provider of services for which individuals are taxed according to the amount of services (or benefits) they receive. The difficulty (or impossibility) of measuring individual receipt of benefits from national defense, foreign aid programs, and so forth, has precluded widespread adoption of benefits received as a base for raising large amounts of federal revenue. Moreover, taxation based on benefits received would be in almost direct conflict with many welfare programs. The benefits approach has, however, been applied on a limited basis in certain federal programs such as Social Security and highway construction. This approach to taxation is best suited to the local level (city governments) where individual receipt of benefits from certain locally furnished services can be approximated.

Ability to pay (as the principle is generally used; it has no precise meaning) has two aspects: (1) a quantitative aspect, a measure of an individual's command over resources that could be turned over to the government--income, property, consumption, a combination of these, or some other index could be used; and (2) a qualitative aspect, some measure of individual sacrifice or hardship involved in giving up resources. Combining these two aspects, ability to pay may be regarded as the capacity to pay taxes without

undue hardship on the person paying.

Although current income is only one measure of an individual's command over resources, it is widely regarded as the best single index of taxpaying capacity. The principal item that could supplement current income is wealth. However, wealth can be resolved into the accumulation of past income or the expectation of future income. Moreover, federal gift and estate taxes supplement federal income taxes, with respect to wealth, by taxing certain transfers of large accumulations of wealth.

The sacrifice aspect of ability to pay has been used mainly to justify the taxation of personal income at progressive rates. Three basic propositions are involved in this justification: (1) equality in taxation means equality of sacrifice; (2) sacrifice in taxation consists of utility (satisfaction) foregone; and (3) as personal income rises, total utility derived from that income increases by decreasing amounts. These three propositions together suggest that tax rates should be progressive to produce equality of sacrifice in taxation. However, attempts to work these and similar propositions into a rigorous approach to distributing tax burden according to individual sacrifice have been discredited and largely abandoned because of the numerous difficulties involved in measuring and comparing individual

sacrifice.[14] Nevertheless, the general notion that income produces diminishing marginal utility and that this dimunition supports progressive income taxation is widely accepted.[15]

Three general features of the federal individual income tax system reflect the main properties of the ability-to-pay principle: (1) personal income as a gross measure of an individual's command over resources--what an individual could turn over to the government; (2) exemption of a minimum (or subsistence) level of income from taxation--effected mainly through $600 exemptions for the taxpayer, his spouse, and children--to avoid producing real hardship in taxation; and (3) taxation of personal income at progressive rates--an attempt to approximate some kind of reasonable distribution of individual sacrifice in taxation.

In spite of numerous disagreements on how the principle of ability to pay should be implemented--in setting tax rates, making allowances for personal circumstances, etc.--this principle is still the most widely accepted standard of equity in the United States.[16] The observations of two

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[14]For an analysis of various sacrifice theories, see: Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), Chapter 5.

[15]Dan Throop Smith, Federal Tax Reform (New York: McGraw-Hill Book Company, Inc., 1961), p. 13.

[16]For a critical minority viewpoint, see: Louis

authorities in the field of public finance serve to substantiate this point:

> My observation is that the majority of citizens and legislators in the United States and other democratic countries accept ability to pay as a guiding principle of taxation and interpret it as justifying progressivity. They talk and act as if they believe that progressive taxation is needed to maintain a proper relation between the sacrifices of individual taxpayers and to give recognition to social priorities in the use of income and wealth. Without assuming that some such beliefs are widely accepted, I find it hard to account for political discourse on taxation or for revenue legislation.[17]

> The principle of distribution of tax burden on the basis of ability to pay is the one which conforms most closely with the generally accepted standards of equity . . . . The principle that accepted standards of equity require that persons who have the same ability to pay should pay equal amounts of taxes and that persons who have greater ability should pay more to the government than those who are less well off is today almost universally accepted.[18]

The tax treatment accorded unincorporated business enterprises (disregarding Subchapter R) has been well accepted among students of taxation because it conforms to the general pattern of progressive taxation based on

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Eisenstein, The Ideologies of Taxation (New York: Ronald Press Company, 1961), Chapter II.

[17]Richard Goode, The Individual Income Tax, Studies of Government Finance (Washington, D. C.: Brookings Institution, 1964), p. 19.

[18]John F. Due, Government Finance: An Economic Analysis (3rd ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 110.

individual ability to pay. Moreover, business income allocated to proprietors and partners is taxed in essentially the same manner as most other types of individual income, such as salaries and wages. On the other hand, the tax treatment accorded corporations (disregarding Subchapter S), has been the recipient of considerable criticism, principally because corporate income is taxed largely without regard to shareholder ability to pay and because only distributed income is taxed directly to shareholders.

A few arguments have, however, been advanced to justify the taxation of corporations as separate entities. First, it has been contended that the corporate income tax is based on corporate ability to pay. This argument involves a confusion of terms. Ability to pay, however imprecise the principle may be, clearly has no application to corporations. One of the principal aspects of ability to pay is sacrifice; inanimate objects, such as corporations, do not experience sacrifice.[19] Moreover, since individuals ultimately bear all the taxes paid by a corporation, there is little to be gained, in terms of equity, by creating a separate rationale for corporate ability to pay.

Another argument is that a special tax on the corporate form of doing business is appropriate because corporations

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[19]Richard Goode, The Corporation Income Tax (New York: John Wiley & Sons, Inc., 1951), pp. 32-37.

enjoy special privileges and benefits, which are granted and protected by the government. This rationale may justify a small gross receipts tax or a similar tax, but it does not justify the corporate income tax. Use of net income as a measure of benefits received is inconsistent in that unprofitable corporations, which also benefit from incorporation, are not taxed. Moreover, the relationship between benefits received from incorporation and corporate profitability has never been established, nor does it appear that any recognized attempt has ever been made to establish this relationship.[20]

The above arguments have, at times, been advanced to justify the taxation of all corporations as separate entities. Other, more subtle arguments, have been advanced to justify the taxation of large, publicly held corporations as separate entities. These arguments and problems associated with revising the tax treatment accorded publicly held corporations to bring it into line with shareholder ability to pay, are examined briefly in Chapter III.

The lack of a widely accepted rationale for taxing corporations as separate entities has led to various proposals for integrating (or coordinating) corporate and

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[20]Tax Foundation, Inc., Reexamining the Federal Corporation Income Tax (New York: Tax Foundation, Inc., 1958), p. 12.

personal income taxation--the partnership method and the dividend received credit are two of these methods. Integration methods are examined in Chapter III, along with their suitability for closely held and publicly held corporations. The taxation of publicly held corporations is examined in Chapter III only insofar as it is necessary to distinguish between problems peculiar to these organizations and those peculiar to closely held corporations. This study does not attempt to examine the need for revising the tax treatment accorded publicly held corporations.

The case for taxing closely held corporations like partnerships, on a mandatory basis, rests principally on equity: (1) horizontal equity, with shareholders of closely held corporations and owners of unincorporated business enterprises viewed as individuals in similar positions, and (2) ability to pay, which specifies the kind of similar tax treatment to be accorded to individuals whose incomes differ. Equity considerations are examined further in Chapter IV.

Administrative and Compliance Factors

Insofar as possible, a tax system should be simple, certain, convenient, and economical in administration. In particular, tax laws should be easy to understand and comply with on the part of taxpayers and easy to enforce on the part

of the government. Among the major indicators of poorly written tax laws, or poorly enforced tax laws, or both are the following: (1) high (relative to the tax paid) compliance or collection costs; (2) a prevalence of opportunities for either successful tax avoidance or tax evasion; (3) an inordinate amount of litigation, reopening of tax determinations of past years, and other unresolved tax determinations; and (4) low taxpayer morale, which may be manifested by an extreme game-like or adversary relationship with the government, or by the belief that tax determinations are, in general, made on an arbitrary or capricious basis. In this connection, the amount or burden of the tax, as well as the opinions of taxpayers about the fairness with which the burden is distributed, also may affect significantly many aspects of taxpayer compliance.

With respect to ease of taxpayer compliance, the Internal Revenue Code contains some of the most complex tax provisions in the United States. Most of the complexity can be attributed to the following: (1) the need to prescribe numerous rules stating how, when, and to what extent, various items are to be included in the determination of taxable income; (2) hardship relief provisions--retirement income credit, head-of-the-household tax rates, etc.; (3) special tax treatment accorded certain types of organizations--real estate investment trusts, certain corporations

engaged in foreign operations, farm cooperatives, etc.; and (4) loophole plugging. Many of these complexities have resulted from spot reactions to special situations, rather than long-term policy developments; non-revenue use of the tax laws (e.g., investment tax credit to stimulate investment); special provisions begetting special provisions (e.g., mutual funds begetting real estate investment trusts); and numerous political, social, and economic forces.

The practical orientation of this study necessitates that much of the existing complexity of the Code--such as that pertaining to hardship relief provisions and to special tax treatment accorded various types of income--be accepted. Tax simplification is a subject that has received a lot of good wishes and lip service in general. However, based upon the record of Congress and the informed opinions of many tax authorities, there appears to be very little chance that any significant degree of simplification will be brought about in the foreseeable future. Neither the existing system of taxing closely held corporations nor the mandatory partnership tax system considered in this study is composed of simple tax rules.

The administrative and compliance problems examined in this study are outlined below. Many of these problems are interrelated with equity considerations.

The corporate tax method. Closely held corporations

have always provided poor subject matter for application of the corporate income tax method. The principal reason for this is that there is no effective separation of ownership and control in these corporations. Usually closely held corporations are owned and managed by a few individuals who are the principal corporate officers. The combination of (1) unity of interest of management and ownership and (2) the relative ease with which the income and dividend policy of closely held corporations can be controlled provides considerable incentive and opportunity for tax avoidance. [Most of the provisions currently contained in the Internal Revenue Code to restrict tax avoidance practices associated with the corporate form have been designed for and applied almost exclusively to closely held corporations. The prevalence of tax avoidance practices among these corporations, coupled with counteractions by the Internal Revenue Service, has produced one of the most arbitrary and game-like administrative climates in the field of federal income taxation.] These tax avoidance practices and counteractions are examined in Chapter II.

Optional partnership tax treatment. Subchapter S, which gives certain closely held corporations the option to be taxed somewhat like partnerships, also has presented many administrative and compliance problems, including the following: (1) increased complexity in tax considerations

involved in selecting a legal form of organization for a small business; (2) difficulties in tax management for those who use the election--e.g., the Subchapter S election will be terminated if the corporation's stock is transferred to one shareholder who does not consent to the election; and (3) use of the Subchapter S election for tax avoidance purposes. Subchapter S is examined in Chapters IV and VII.

The mandatory system. Mandatory application of a partnership tax system to closely held corporations would eliminate much of the uncertainty and arbitrariness in tax determinations which characterize the existing system of taxing closely held corporations, both under the corporate tax method and Subchapter S. However, the mandatory system would present other problems. One prevalent tax avoidance practice that would be eliminated is the retention of corporate income under the corporate tax method to avoid higher personal income taxes at the shareholder level. Among the administrative problems that would be added by the mandatory system are the following: establishing criteria for distinguishing between closely held (private) corporations and widely held (public) corporations; determining what to do with those that do not fall neatly into either category; and setting-up provisions to keep corporations from avoiding the mandatory system if they find it advantageous to do so. These problems are examined in Chapters IV, VI, VII.

Another problem considered in this study is the nature of the partnership tax treatment to be provided under the mandatory system. In general, the partnership method of taxing business income calls for allocating all the income (whether distributed or not) or loss to the owners to be included in the determination of their individual tax liabilities. Both Subchapter S and Subchapter K (the regular partnership tax system) accomplish this basic objective. However, these subchapters contain two different sets of rules for determining and allocating income or loss. Although the tax rules contained in neither subchapter could be applied, without modification, to closely held corporations on a mandatory basis (as explained in Chapter VII), these subchapters contain rules from which the bulk of those used in a mandatory system could be selected.

This study does not, however, attempt to select or formulate the specific rules that would make up the mandatory partnership tax system; writing a tax system is a committee project requiring a host of experts in various fields. This study does provide a broad outline of the tax rules that would be suitable for the mandatory partnership tax system. These rules and procedures are discussed in Chapters VI and VII.

Economic Consequences

Among the economic criteria by which a tax system may be evaluated are: amount and stability of the revenue yield; how the system contributes to stability in the economy; and effects of the system on prices, wages, incentives, capital formation (or growth), and a number of other items. Many of these effects are frequently lumped into the phrase, impact of the tax.

Imposition of minimal restraints on economic growth is one of the most important objectives of tax policy. Neutrality in taxation, which, in general, means that taxes should not be used to influence consumption, investment, or other economic decisions, is frequently cited as another desirable objective. However, the present level of income taxes precludes any significant degree of neutrality; this is especially the case in many aspects of business decision making. Moreover, the investment tax credit, accelerated depreciation, and percentage depletion in the petroleum industry are just a few of the examples in which the government has abandoned the neutrality objective.

Although this study deals with both the corporate and the individual income tax systems, as applied to closely held corporations, an examination of how these systems affect the economy as a whole is beyond the scope of this study. There are a number of studies in the field of public

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finance that deal with these matters.[21] Moreover the changes in the tax treatment accorded closely held corporations considered in this study are not likely to have significant effects on the economy as a whole.

The economic considerations treated in this study are limited principally to the following: (1) effects on incentives of individuals to form, work in, and expand closely held business enterprises; (2) effects on incentives of individuals to invest in closely held business enterprises; (3) effects on the availability of funds after taxes to finance the growth of small businesses; and (4) estimated change in total tax revenue resulting from the adoption of the mandatory partnership tax system. These topics are examined in Chapter VI.

Related to both the determination of economic effects and equity in taxation is the question of the incidence of the tax--who ultimately bears the tax? There is substantial agreement among economists that individual income taxes are, in general, borne by those who pay them, including the individual taxes paid by owners of unincorporated business enterprises. On the other hand, there is substantial

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[21]See: Marian Krzyzaniak, ed., Effects of Corporation Income Tax (Detroit: Wayne State University Press, 1966); Goode, The Corporation Income Tax, and The Individual Income Tax, op. cit.; and Musgrave, op. cit.

disagreement among economists on the extent to which the corporate income tax is borne by shareholders, shifted forward in the form of higher prices to consumers, or shifted backward in the form of lower wages and other factor payments.[22]

The uncertain incidence of the corporate income tax is not crucial to the findings of this study for the following reasons: (1) over half of all closely held corporations pay little or no corporate income taxes year after year (explained in Chapter II). (2) Many, if not most, closely held corporations which pay a significant amount of corporate income taxes are used, in part, to avoid higher personal income taxes at the shareholder level. If the latter corporations are able to shift all or part of the corporate income taxes paid, the serious inequity associated with using the corporate form to avoid higher personal income taxes is merely intensified. (3) Most of the incidence uncertainty pertains to taxes paid by large, publicly held corporations, which are in a position to administer prices and significantly influence other aspects of factor and output markets. The fact that closely held corporations (which are predominately small businesses) compete mainly with unincorporated

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[22]An examination of various theories and studies of corporate tax incidence is beyond the scope of this study. These theories and studies are examined in the works cited in n. 21, above.

business enterprises (which do not pay corporate taxes) lends strong support to the assumption that closely held corporations are not able to shift a substantial portion of the corporate taxes they pay. For purposes of this study, it is assumed that both corporate and individual taxes applicable to the closely held corporations are borne by shareholders.

Constitutionality of Mandatory Partnership Tax Treatment

Another issue examined in this study is the constitutionality of taxing closely held corporations like partnerships on a mandatory basis. Various interpretations of the Sixteenth Amendment and of a few landmark court cases indicate that it would be unconstitutional to tax corporations in this manner; other interpretations indicate the opposite. In this connection, it should be noted that Subchapter S does not raise the question of constitutionality; the special tax treatment provided by this subchapter is optional and all shareholders must consent to the election before it can be used. The only mandatory partnership tax treatment presently prescribed by the Code is that applied to certain closely held foreign corporations.[23] The latter, however, offers no clear precedent for similar tax treatment for domestic corporations. The constitutional issue is examined in Chapter V.

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[23]I.R.C. (1954), secs. 551-58, 951-64.

Limitations on the Scope of the Study

In addition to limitations noted previously, an examination of the following is beyond the scope of this study: (1) relationships between federal income taxation and other forms of taxation; (2) theoretical deficiencies of statutory concepts of taxable income as compared with various economic and accounting concepts of income; (3) non-tax reasons for selecting an incorporated or unincorporated legal form of business organization (including considerations such as limiting the liability of owners, ethical codes of various professions, and state tax laws); (4) problems associated with classifying joint ventures, groups, pools, syndicates, and similar organizations for tax purposes (these organizations are classified for tax purposes as either partnerships or corporations, depending upon whether the legal and operating characteristics of the organizational form in question most closely resemble those of a partnership or a corporation); and (5) special forms of tax treatment accorded certain types of organizations (including real estate investment trusts, certain banks and insurance companies, nonprofit organizations, small business investment companies, mutual funds, farm cooperatives, businesses engaged in foreign operations, and others).

Even though most of the areas listed above are related directly or indirectly to the subject matter at hand, it

would be virtually impossible to consider all of these peripheral areas in this study. In addition, consideration of these peripheral areas would detract considerably from the main theme of this study.

For the foregoing reasons, this study is conducted largely within the framework of existing tax laws and deals almost exclusively with what may be regarded as ordinary businesses--i.e., profit-making enterprises organized as corporations, general partnerships, or proprietorships; engaged solely in domestic operations which do not call for a special tax classification of the organization. One exception to the ordinary business limitation is the inclusion in this study of domestic personal holding companies (defined in the next chapter).

Method of Research

The analysis and conclusions contained in this study are based on an examination of the following: (1) basic sources of tax law (Internal Revenue Code, Treasury Regulations, court cases, Congressional hearings, etc.); (2) studies dealing with various aspects of federal income taxation (including equity, administrative and compliance problems, economic effects, and constitutionality); and (3) statistical data gathered by the Internal Revenue Service, the Securities and Exchange Commission, and other organizations.

CHAPTER II

TREATMENT OF CLOSELY HELD CORPORATIONS UNDER THE CORPORATE INCOME TAX SYSTEM

This chapter examines the major problems involved in applying the corporate income tax method to closely held corporations. Primary consideration is given to tax avoidance and certainty (or finality) in tax determinations. The purpose of this chapter is to establish, in part, the need for considering a different system of taxing closely held corporations.

Approaches to Tax Minimization

Although it is frequently assumed that the double taxation of business income under the corporate tax method imposes a higher tax burden on shareholders of closely held corporations than on proprietors and partners in similar economic circumstances, this is not necessarily the case. Whether the tax burden of shareholders of a given closely held corporation is higher or lower than it would be if the same operations were conducted under an unincorporated business form is dependent upon a number of factors. Among these factors are the nature of business activities, how and when

corporate income is distributed , and individual tax brackets of shareholders. Shareholders of closely held corporations have considerable latitude in arranging the best combination of corporate and individual income taxes to minimize their aggregate tax burden.

There are three general approaches to minimizing the tax burden of shareholders of closely held corporations: (1) distribution of current corporate earnings in the form of expense payments to shareholders to reduce corporate income and thereby avoid the corporate tax on the income distributed; (2) retention of corporate income to avoid higher personal income taxes at the shareholder level; and (3) use of multiple corporations to have all or a greater portion of corporate income taxed at 22 percent, rather than 48 percent. In the following sections these general approaches are discussed first, and then the countermeasures used by the Internal Revenue Service are examined. Tax planning measures common to all businesses (adjusting depreciation lives, etc.) are not discussed in this study.

Distributions of Current Corporate Earnings

Since dividend distributions of corporate income are taxed first at the corporate level and again at the shareholder level (i.e., the amount exceeding the $100 dividend exclusion), careful tax planning calls for keeping dividend distributions of current earnings to a minimum, regardless

whether shareholders are in high or low tax brackets. The principal way the corporate tax on these distributions can be avoided is by making the distributions in the form of expense payments to shareholders, which are deductible in computing corporate income, rather than in the form of dividends, which are non-deductible.

Although any kind of valid business expense payment to shareholders will serve to avoid double taxation of the income distributed, these payments are usually made in one or more of the following forms: (1) salaries, bonuses, and other compensation paid to officer-shareholders (the most common form); (2) interest paid to shareholders who lend money to the corporation rather than contribute capital for additional stock; and (3) rent paid to shareholders (e.g., one practice is to incorporate part of a business and lease the unincorporated assets to the incorporated part of the business). Once the amount or percentage of corporate income that is to be distributed on a current basis has been determined (as explained below), expense payments can be arranged accordingly. These payments must, of course, at least maintain the appearance of valid business expenses, or they may be disallowed by the Internal Revenue Service (discussed below).

The amount or percentage of current corporate earnings that should be distributed as expense payments for tax

minimization is determined, in large part, by the individual tax brackets of shareholders. Current corporate tax rates are 22 percent of the first $25,000 of income and 48 percent of the excess; individual rates range from 14 to 70 percent. Individuals in the lower individual tax brackets usually find it advantageous to eliminate substantially all of the income at the corporate level and pay little or no corporate taxes, even though in many cases the expense payments received by the shareholders must be immediately reinvested in the corporation for business purposes.

The prevalence of this siphoning process is indicated by the following statistics: in 1962, 1,195,614 corporations had assets totaling less than $1 million; of which, 69 percent reported a net loss, equal receipts and deductions, or taxable income of less than $5,000.[1] For the same group, the total compensation paid to corporate officers was equal to approximately twice the total net income of the group. Dividend distributions in cash or other property (excluding stock dividends) amounted to only 9 percent of total net income before deducting compensation paid to officers.[2]

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[1]U. S. Treasury Department, Inteneral Revenue Service, Statistics of Income, 1962, Corporation Income Tax Returns, with accounting periods ended July 1962-June 1963. (Washington, D. C.: Government Printing Office, 1966), p. 206.

[2]Ibid., p. 58. These figures include data for 122,856 corporations that filed under Subchapter S in 1962. Data for Subchapter S corporations are reported in essentially the same

Countermeasures. To restrict the above practices, the Internal Service has sought to disallow (as corporate deductions) salaries, interest, and other payments to shareholders to the extent that these payments have been judged to be disguised dividends. A brief review of the areas of "unreasonable compensation" and "thin capitalization" will serve to point out (1) the problems involved in distinguishing between valid expense payments and disguised dividends and (2) how these problems are restricted to closely held corporations.

Unreasonable compensation. With respect to the disallowance of excessive compensation, section 162(a) of the Code permits a taxpayer (including a corporation) to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered."[3] Unfortunately, there are no objective standards for determining the reasonablesness of compensation. One study involving an analysis of over 700 court cases dealing with unreasonable compensation, lists over thirty criteria which have been used in attempting to settle disputes between taxpayers and the

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manner as that for corporations subject to the corporate tax method.

[3]I.R.C. (1954), sec. 162(a) (1).

Internal Revenue Service.[4] Among these criteria are the nature of duties performed by officer-shareholders, size of business, compensation of officers in comparable positions in other businesses, training of the officers, amount of time required, and general living conditions in a particular locality.[5]

The same study is prefaced with the following observations:

> While there is nothing in either the Code or the Regulations thereunder that limits the application of this Section [162(a) above]. . . the question is primarily directed against the officer-stockholders of the closely held corporation. . . . This is because in such companies it is often quite easy for the officer-stockholders to control the payment of amounts to themselves, which amounts, in whole or in part, might be construed under the facts in the case as being dividends even though labeled throughout the company's records as compensation.[6]

Thin capitalization. A "thin corporation" is one financed by a high ratio of debt to equity capital supplied by the shareholders of the corporation. The main purpose of thin capitalization is to maximize the interest deduction for

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[4]Crawford C. Halsey and Maurice E. Peloubet, Federal Taxation and Unreasonable Compensation (New York: Ronald Press Company, 1964), pp. 2-17.

[5]Ibid.

[6]Ibid., p. 1-2.

distributions of current corporate earnings to shareholders. The interest deduction of a corporation that is too "thinly" capitalized may be disallowed and treated as a dividend to the extent that the Internal Revenue Service is able to sustain the case that all or part of the debt capital is in reality equity capital.

What determines whether capital is debt or equity? According to one leading case: "There is no one characteristic, not even exclusion (of shareholder-creditors) from management, which can be said to be decisive in the determination of whether obligations are risk investments in the corporation or debts."[7] Some of the characteristics that have been relied upon to sustain the case that debt is in reality equity capital are: interest rates dependent upon earnings, lack of a definite debt maturity date, subordination of debt held by shareholders to claims of other creditors, and switching of stock into debt. With respect to an acceptable ratio of debt to equity, the courts have never adhered to any given ratio.[8] In general, the higher the ratio of debt to equity capital held by shareholders, the more likely the interest deduction will be challenged by the Internal Revenue Service.

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[7]John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).

[8]Martin M. Lore, Thin Capitalization, Tax Practitioners' Library (New York: Ronald Press Company, 1958), pp. 11-31.

One study of cases involving the thin corporation problem has pointed out the extent to which this problem is limited to closely held corporations:

> This corporation is strictly a problem of closely held corporations. There is no problem of this corporation in a truly widely held corporation, since it is practically impossible for hundreds or thousands of stockholders to hold the corporation's debt in proportion to their stockholdings. Furthermore, the courts are more apt to question the motives of a few stockholders in absolute control of their close corporation, than to scrutinize the motives of a large number of unrelated stockholder-creditors of a large and widely held corporation.[9]

Retention of Corporate Income

As opposed to individuals in low tax brackets, who usually find it advantageous to avoid the corporate income tax, those in high tax brackets frequently find the corporate income tax a desirable alternative to higher personal income taxes. Through careful tax planning, substantial amounts of income may be retained and accumulated in closely held corporations, where it may be shielded from personal tax rates that are higher than corporate rates.

Corporate income accumulated in this manner may subsequently be distributed or disposed of in one or a combination of three basic ways for tax minimization:

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[9] Ibid., pp. 3-4.

1. The income may be distributed as dividends during years in which shareholders have incurred losses (which may be offset against the dividends) or during years in which shareholders receive small amounts of income from other sources (e.g., after they retire).

2. The accumulated income may be distributed to shareholders as long-term capital gain (which is subject to a maximum tax of 25 percent). Long-term capital gain (on stock held over 6 months) may be realized by the selling the corporate stock or by fully or partially liquidating the corporation (under certain conditions). Income retained in the corporation--to the extent that this income has increased the value of the stock sold or is received as liquidation proceeds--is thereby converted into long-term capital gain.

3. The accumulated income may not be distributed. Shareholders may retain the corporate stock until they die; in which case, the stock will enter their estates at current market value, and no individual income taxes will be paid on the income retained in the corporation. In addition, heirs receive the stock with a tax basis that includes the appreciation.[10]

Countermeasures. The code contains two special penalty taxes which may be imposed on corporations which have

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[10] I.R.C. (1954), sec. 1014.

improperly accumulated income to avoid higher taxes at the shareholders level: the personal holding company tax and the accumulated earnings tax. The purpose of these taxes is to force a greater distribution of corporate income to be taxed to shareholders as ordinary income. In addition, the Code contains several provisions to restrict the practice of distributing accumulated corporate income as long-term capital gain.

Personal holding company tax. The specific function of this tax can best be explained in light of two practices which were common prior to 1934, the year in which the first personal holding company provisions were enacted: (1) Some wealthy individuals transferred substantial amount of income producing property (stock, bonds, copyrights, etc.) to corporations which they or their close associates wholly owned. Income was received by and accumulated in these corporate shells, where it was taxed at corporate rates that were considerably lower than the individual rates applicable to income received by the owners of the corporations. (2) Some successful entertainers and other individuals with high personal-service income formed private corporations, had these corporations contract to sell their services, and then worked for these corporations for nominal salaries. The differences between the fees received by these corporations and the salaries paid to the talented persons

were accumulated in the corporations. In both of the above cases, the ultimate objective was to distribute or dispose of the accumulated income in one or a combination of the three ways described above.[11]

To curtail these practices, a heavy penalty tax has been imposed upon the undistributed income of personal holding companies. Under the current law, a corporation is considered a personal holding company if it satisfies two basic requirements: (1) it is more than 50 percent owned, directly or indirectly, by not more than five individuals; and (2) at least 60 percent of its gross income consists of personal holding company income, which includes dividends, interest, some types of royalties, certain rental income, and certain personal-service income.[12] A corporation may be a personal holding company in some years and not in others, depending upon whether it satisfies the twofold definition stated above. The personal holding company tax is 70 percent

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[11]Harry J. Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," Yale Law Journal IL (December, 1939), pp. 171-205.

[12]I.R.C. (1954), secs. 542-43. Certain financial institutions--including banks, life insurance companies, and most finance companies--and certain foreign corporations are not subject to this tax.

of undistributed personal holding company income.[13]

The personal holding company provisions have not eliminated, but merely limited the extent to which, the closely held corporate form may be used as a device for shielding investment income and personal-service income from high personal tax rates. A corporation whose gross income consists of 59 percent personal holding company income is not a personal holding company, nor is a corporation that fails to satisfy any of several other requirements pertaining to certain kinds of income or to corporate ownership; arranging corporate affairs to fail to satisfy the statutory definition of a personal holding company is a common tax-planning maneuver in this area.

Accumulated earnings tax. Sections 531-37 of the Code specify that a penalty tax may be imposed on a corporation that improperly accumulates earnings for the purpose of avoiding the individual income tax on shareholders. These provisions apply to all domestic, profit-making corporations, other than personal holding companies. Evidence of intent to avoid the individual tax may be provided by (1) accumulation of earnings beyond the reasonable needs of the

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[13]I.R.C. (1954), sec. 541. Several complicated steps are involved in computing this tax. These steps are explained in most standard tax reference manuals.

business or (2) use of the corporation as a mere holding or investment company. The latter is considered prima facie evidence of intent to avoid the individual tax.[14] However, extensive use of a corporation as a holding device will, in many cases, result in the corporation being classified as a personal holding company. Thus, the reasonableness of accumulations of earnings for business purposes is the principal issue involved in imposing this tax.

The accumulated earnings tax is 27-1/2 percent of the first $100,000 of accumulated taxable income and 38-1/2 percent of the excess.[15] "Accumulated taxable income" is not the same as the balance of the retained earnings account; several special adjustments must be made to convert retained earnings into "accumulated taxable income."[16] Nevertheless, for expository purposes, it is useful to think of accumulated taxable income as being the balance of the retained earnings account, as reduced by the accumulated earnings credit, which is the larger of (1) the amount of retained earnings required to meet the reasonable needs of the business or (2) $100,000

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[14] I.R.C. (1954), sec. 533.

[15] I.R.C. (1954, sec. 531.

[16] An explanation of the steps involved in computing this tax can be found in most standard tax reference manuals.

the minimum accumulated earnings credit.[17] In general, a corporation may accumulate $100,000 of current and past taxable income without incurring any liability for the accumulated earnings tax.

Unlike the personal holding company tax, which a corporation is supposed to determine and pay with its regular corporate income tax if the tax is required, the accumulated earnings tax is levied as a result of audit by the Internal Revenue Service. Another important difference between these taxes is that the accumulated earnings tax is imposed on the basis of subjective standards (intent to avoid, reflected by unreasonable accumulations); whereas the personal holding company tax is imposed on the basis of objective standards (e.g., the 60 percent personal holding company income test). The element of intent is irrelevant in determining whether the personal holding company tax is to be imposed.

Accumulated earnings (penalty) tax provisions, although revised several times since their inception, have remained in the tax laws since 1921. Under section 102 of the 1939 Code, there was no minimum accumulated earnings credit and the burden of proving the reasonableness of retaining a given amount of corporate income was on the corporation. In

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[17] I.R.C. (1954), sec. 535.

addition, under section 102, the immediacy test was generally applied. According to this test, funds not required for current business operations were being unreasonably accumulated if not distributed by the end of the year.[18]

Complaints that section 102 was being administered arbitrarily with the result that many small corporations were forced either to distribute funds needed in the business or to pay the proposed deficiency to avoid expensive litigation, prompted several important changes in the accumulated earnings tax provisions. The 1954 Code contained three important changes: (1) exemption of a minimum amount of accumulated earnings from the penalty tax--$60,000 in 1954 (raised to $100,000 in 1958); (2) shift of the burden of proof concerning the reasonableness of the income retained from the corporation to the Internal Revenue Service--this is presently the usual case; and (3) broadening of the reasonableness principle to include not only current business needs, but also reasonably anticipated (future) needs of the business.[19]

Some students of taxation maintain that these changes

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[18]Stanley S. Weithorn and Roger Noall, Penalty Taxes on Accumulated Earnings and Personal Holding Companies, Practicing Law Institute Tax Monographs (New York: Practicing Law Institute, 1963), pp. 1-5, 42-46.

[19]U. S. Senate Committee on Finance, Internal Revenue Code of 1954, S. Rept. 1622, 83rd Cong., 2nd Sess., 1954, pp. 68-70.

reduced substantially the effectiveness of these provisions; others maintain the current provisions and their administration are still too harsh. Certainly, exemption of a given amount of accumulated income ($100,000) from the tax provides an open invitation to accumulate to that amount and incentive to use multiple corporations to obtain multiple $100,000 credits. Who, in reality, has the burden of proof regarding the reasonableness of income accumulations is usually a moot question, when each party is trying to discredit the contentions of the other party. Expansion of the reasonableness test to include reasonably anticipated (future) needs of the business has definitely expanded opportunities for extensive litigation.

What constitutes the current and reasonably anticipated (future) needs of a business? The following items or a combination of them may justify retention of income: (1) current operating expenses; (2) low liquid position; (3) reserve for a pending law suit; and (4) fairly definite plans for replacement of equipment, or additions to plant and equipment, or product diversification, or acquisition of another business, or a host of other items. On the other hand, conditions such as the following are likely to cast doubt on the reasonableness of the amount of income retained: (1) loans to shareholders (2) investments in securities or properties which are substantially unrelated to the corporation's

regular business activities; (3) vagueness of plans for replacements of or additions to business plant and equipment; and (4) retention of income to provide against unrealistic hazards.[20]

The extreme subjectivity involved in applying the accumulated earnings tax has been described by two tax attorneys as follows:

> The answering, preparation for trial, trial and briefing of a section 531 case extends one across the waterfront of human existence. Almost anything imaginable is relevant when you are dealing with such items as "reasonable needs" and "intent to avoid shareholder taxes."[21]

Although not specifically stated in the Code or the Regulations, the accumulated earnings tax has been applied almost exclusively to closely held corporations. The Senate Finance Committee Report issued in connection with the 1954 Code noted that the tax had been imposed on corporations only where 50 percent or more of the stock was held by a limited group.[22] There is one well-known case in which this tax has been imposed on a publicly held corporation. The corporation in question had approximately 2,000 shareholders; however,

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[20]Weithorn and Noall, op. cit., pp. 12-42.

[21]Edward L. Newberger and Wallace E. Whitmore, "Accumulated Earnings Tax Cases," The Tax Executive, XVIII (January, 1966), p. 149.

[22]Internal Revenue Code of 1954, S. Rept. 1622, op. cit., p. 69.

six shareholders controlled about two-thirds of the shares.[23]

Capital gain distributions. Subchapter C of the Code contains a maze of provisions designed to curtail the practice of distributing accumulated corporate income as long-term capital gain through the use of devious forms of stock redemptions, corporate liquidations, and other forms of corporate distributions. Preferred stock bailout rules provide a good example of the general nature of these provisions. A bailout works as follows: a corporation issues a non-taxable stock dividend on common stock (paid in preferred stock) to shareholders who sell the preferred stock at a gain (ordinarily a capital gain) to a third party (a financial institution or other intermediary) from whom the corporation redeems the stock. Under section 306 of the Code, the gain (all or part of it) on the sale of the stock by the shareholders may be treated as ordinary income on the grounds that the transaction is "essentially equivalent to a dividend."

In the bailout example, the case is relatively clear as to the real nature of the transaction. On the other hand, the variety of ways in which corporate distributions

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[23]Trico Products Corp. v. Commissioner, 137 F. 2d 424 (2d Cir. 1943), cert. denied, 320 U. S. 799 (1944).

may be made (in particular, by closely held corporations) have presented the courts with some formidable problems in attempting to settle disputes over the real nature of various corporate distributions.[24] Closely held and publicly held corporations have little in common with respect to opportunity and incentive to make unorthodox income distributions.

Multiple Corporations

A practice which enhances the tax savings on corporate income is the use of two or more corporations to obtain multiple surtax exemptions to keep all or a large portion of corporate income in the lower corporate bracket. Current corporate rates consist of a 22 percent normal tax and a 26 percent surtax; in general, each corporation is permitted one $25,000 surtax exemption. A maximum annual tax savings of $6,500 (26 percent of $25,000) may be obtained for each additional corporation.

In 1962, when the corporate normal rate was 30 percent and the surtax was 22 percent, a maximum annual savings of $5,500 (22 percent of $25,000) could have been obtained for

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[24] For an analysis of cases in this area, see: Paul D. Seghers, William J. Reinhart, and Selwyn Nimaroff, Essentially Equivalent to a Dividend, Tax Practitioners' Library, (New York: Ronald Press Company, 1960).

each additional corporation. In that year, 724,903 corporations had both assets of less than $1 million and taxable income. Only 13 percent of these corporations reported taxable income in excess of $25,000.[25] The use of multiple corporations probably accounted, in large part, for this low percentage.

Countermeasures. The intent of Congress in enacting and maintaining the corporate surtax exemption has been to provide tax relief for small (incorporated) businesses. Congress and the Internal Revenue Service have, however, encountered numerous problems in seeking to limit the benefits of the exemption to "small businesses." Several provisions have been added to the Code to curtail the practice of dividing an economic entity into a series of artificial legal entities for the principal purpose of obtaining multiple surtax exemptions.

Sections 1561-63 of the Code (initiated with the Revenue Act of 1964) provide that certain controlled groups of corporations may elect to take either (1) only one $25,000 surtax exemption for the entire group or (2) one surtax exemption for each corporation and pay an additional 6 percent tax on the first $25,000 of income of each

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[25] Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., pp. 206-7.

corporation. Controlled groups of corporations, for purposes of these sections, fall into two general categories: parent-subsidiary corporations, with the parent usually owning at least 80 percent of the voting stock of each of its subsidiaries and brother-sister corporations, with one individual, trust, or estate owning 80 percent of each of two more corporations.

Since the election of multiple surtax exemptions, under these provisions, can still produce a maximum annual tax savings of $5,000 ($25,000 x 48-28 percent) for each additional corporation, the enactment of these provisions has done little to reduce the incentive to use multiple corporations. Only in exceptional situations will controlled groups of small, privately held corporations elect to use either one surtax exemption or alternative provisions for filing consolidated tax returns (consolidation is available only to certain parent-subsidiary groups).[26]

In addition to the above restrictions, the Internal Revenue Service may seek to either formally disallow or, in effect, eliminate multiple surtax exemptions and accumulated earnings tax credits. There are three broad avenues of attack

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[26]Also, certain parent-subsidiary groups which cannot, or do not, elect to file consolidated tax returns may elect a 100-percent dividend received deduction for intercompany dividends when only one surtax exemption is used. I.R.C. (1954), sec. 243 (b).

available to the Service:

1. Section 1551 of the Code provides that if (a) any corporation transfers all or part of its property (other than money) to another corporation, "created for the purpose" of acquiring such property, and (b) if the transferor corporation or its stockholders are in control of the transferee corporation during any part of the taxable year, then the transferee corporation shall not be allowed the surtax exemption or the accumulated earnings credit unless it can establish by a "clear preponderance of the evidence" that the securing of the additional exemption or credit was not a "major purpose" of the transfer. The same rule applies where five or fewer individuals make similar transfers to a corporation which they also control.

2. Section 269 specifies that the additional surtax exemption and accumulated earnings credit may be disallowed where the "principal purpose" of acquiring the stock or property of a corporation is to obtain these or other tax benefits. Two types of acquisition are covered by this provision: (a) one or more persons acquire, directly or indirectly, the control of a corporation; (b) a corporation acquires the property of another corporation and the basis of the property is carried over to the acquiring corporation.

3. Section 482 provides that if two or more business organizations are owned directly or indirectly by the same

interests, the Service may allocate gross income, expenses, and credits among the related organizations if this action is necessary to prevent tax evasion or to reflect clearly the income of the organizations involved. Under this provision, if corporate separations are a sham, the Service may attempt to transfer all the income and deductions of the related corporations to one corporation to reflect income clearly. Although section 482 does not call for a formal disallowance of the additional surtax exemptions and accumulated earnings credits, the effect of allocating all the income of a related group of corporations to one corporation is essentially the same as formal disallowance.

These provisions, which, in general, call for making distinctions between corporate separations which have a "sound business purpose" and those which are made principally for tax avoidance purposes provide another fertile area for litigation and uncertainty in taxation.[27] As described in one authoritative work:

> . . . whichever method of attack is adopted by the Commissioner, the inherently factual nature of these problems further ensures the perpetuation of a high degree of uncertainty. Also, in many multiple corporation situations, taxpayers have little to lose by attempting the multiple corporation ploy:

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[27]For an analysis of cases in this area, see: Robert S. Holzman, Sound Business Purpose, Tax Practitioners' Library (New York: Ronald Press Company, 1958).

> i.e., the additional taxes assessed as a deficiency if the multiple set-up fails are likely to be the same as those that would have been imposed had a single corporate entity been used at the outset. This atmosphere is not conducive to the reduction of litigation; taxpayers who get caught in a multiple corporation scheme may feel that they have merely "played the game and lost," and that the next go-around may bring more fortunate results. A system of legal rules which fosters, or even tolerates, such an attitude seems destined for eventual judicial or legislative reappraisal.[28]

Although not limited to closely held corporations, the multiple corporations problem is far more common among these corporations than among publicly held corporations. Comparatively few publicly held corporations are in a position to conduct their operations under a series of sham corporate forms or to engage in devious forms of reorganizations. The multiple corporations problem is discussed further in Chapter VI.

A General Evaluation

What is wrong with applying the corporate tax method to closely held corporations? In addition to the lack of a generally accepted equity rationale for taxing these corporations as separate entities, this approach is undesirable in that it encourages tax avoidance and produces a highly capricious form of taxation with respect to certainty (or

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[28]Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders (2nd ed.; Hamden, Conn.: Federal Tax Press, 1966), p. 672.

finality) in tax determinations.

Entity income and tax avoidance. A straightforward application of the corporate tax method requires the existence of a fairly definite measure of entity income. Whether or not a closely held corporation has taxable income is determined, to a large extent, by the tax brackets of shareholders and the tax sophistication with which corporate income distributions are planned. The relative ease with which (1) shareholders in low tax brackets can convert the corporation into a non-taxable conduit and thereby avoid the corporate income tax and (2) shareholders in high tax brackets can convert the corporation into a shield against higher individual income taxes makes the entire approach an undesirable way of taxing closely held corporations. There is probably no other major area of federal income taxation where the incentive and opportunity for tax avoidance is as clear and prevalent as it is in this area.

With respect to individuals in low tax brackets, it has been contended that there is little need for taxing closely held corporations as partnerships, since so many of these corporations pay little or no corporate income tax--their income is siphoned off as salaries, interest, and rent paid to shareholders. In terms of tax burden, the results of draining a corporation of taxable income in this manner are, in many cases, similar to those achieved under the

partnership method. However, the effects on taxpayer morale and on future tax litigation are not likely to be the same. Flagrant tax manipulation, coupled with arbitrary counteractions on the part of the Internal Revenue Service, weakens the self-compliance foundations of the federal income tax system.

Provisions to restrict tax avoidance. In evaluating the accumulated earnings tax provisions, one tax authority has observed:

> The basic difficulty is the implicit assumption that the motivation of retention of corporate earnings can be strictly classified as either tax avoidance or normal business purposes. Tax avoidance or postponement for stockholders doubtless figures among the considerations entering into the decision to retain earnings in most closely held corporations. . . . The tax avoidance or postponement occurs no matter how legitimate the business needs for retained earnings. The attempt to make the sharp distinction gives rise to a good deal of confusion and a certain amount of hypocrisy.[29]

The same points could be made with respect to the provisions which disallow multiple surtax exemptions unless the use of multiple corporations has a "sound business purpose" and to other tax avoidance provisions discussed previously.

Tax avoidance provisions based on determination of either taxpayer "intent" in engaging in various transactions or "reasonableness" in amount in allowing certain transactions are always difficult to administer in a non-arbitrary

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[29]Goode, The Corporation Income Tax, op. cit., p. 199.

manner. The group of provisions described in this chapter probably calls for more of this general kind of subjectivity in tax enforcement, as applied to closely held corporations, than any other major group of similar provisions in the Code.

Revising these provisions to make them more objective is not a feasible solution. There is no way to set objective standards--to be applied to corporations in all industries, in all kinds of situations--for determination of reasonable salaries, acceptable ratios of debt to equity capital, amount of income needed to be retained in the business, and so forth. Objective standards such as those employed under the personal holding company provisions (e.g., the 60-percent personal holding company income test) are just as arbitrary as the "intent" and "reasonableness" provisions. Moreover, they are often easier to avoid--for example, by having a 59-percent personal holding company.

On the other hand, there is a way to avoid the dilemma of designing tax-avoidance control provisions based on (1) intent and reasonableness or (2) arbitrary objective standards: adopt a tax method in which these provisions are not needed. Under the partnership method of taxation, all the income of a business enterprise, whether distributed or not, is taxed directly to the owners. Thus, under this method of taxing closely held corporations, distribution of

income as salaries or interest, as opposed to dividends; retention of corporate income, as opposed to distribution; and splitting of income through the use of multiple corporations produce little or no differences in tax consequences. The partnership method is examined in subsequent chapters.

CHAPTER III

INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXATION

The partnership method of taxing business income, as applied to corporations, is one of several methods of integrating (or coordinating) corporate and individual income taxation. The purpose of integration is to tax corporate income to shareholders, on the basis of their ability to pay, rather than to the corporation as a separate entity.

This chapter describes the principal integration methods and examines their suitability for taxing closely held and publicly held corporations. The purposes of this chapter are: (1) to exclude from further consideration integration methods other than the partnership method for closely held corporations and (2) to point out some of the major differences between closely held corporations and publicly held corporations with respect to integration.

Integration Methods

Partnership method. This method is the only method that completely integrates the taxation of corporate income. The partnership method requires that the corporate income tax be eliminated and that all the income of corporations,

whether distributed or not, be allocated to shareholders to be taxed as part of their personal income, as is done in the case of unincorporated business enterprises. Subchapter S and the mandatory partnership tax system considered in this study are both variations of the partnership method of integration.

The partnership method has been widely recommended as a desirable method of taxing closely held corporations, which have simple capital structures and operating characteristics similar to those of partnerships. On the other hand, there is substantial agreement among students of taxation that this method is unsuitable for large, publicly held corporations for the following reasons:

1. The complicated capital structures, frequent changes in stock ownership, and large number of shareholders of publicly held corporations would present formidable administrative and compliance problems in applying this method.

2. The typical shareholder of a publicly held corporation has little or no effective control over dividend policy. If shareholders of these corporations were taxed on their shares of undistributed corporate income, they would be subjected to a tax on income which they had not realized and over whose disposition they could exercise no real influence. Hardship in paying taxes would result in many cases and shareholders would be discouraged from buying

stock in these corporations.

3. The taxpaying capacity of shareholders of publicly held corporations consists of realized income (dividends) and income which could be realized (the change in the market value of their stock). The market value of common stock of publicly held corporations is based on the capitalized value of the expected future stream of dividends (or earnings, depending upon the approach taken). Since undistributed corporate income is merely one factor that influences expectations with respect to future streams of dividends; undistributed income, in many cases, does not provide a good measure of taxpaying capacity on the part of shareholders.

Dividends paid deduction method. Under this method, corporations are permitted to deduct dividends in computing income subject to the corporate tax--in the same manner as corporations presently deduct interest on bonds. This approach, in effect, makes the corporate income tax an undistributed profits tax. This method is discussed with the withholding method.

Withholding method. (also called the gross-up method). Under this method, a tax is imposed on the entire income of a corporation, but this tax is regarded as a withholding on the individual income tax of shareholders to the extent that corporate income is distributed as dividends. Shareholders include as personal income the cash dividend received plus

the prorated amount of the withholding tax. Individual tax rates are applied to the grossed-up amount of the dividend and the withholding tax is offset against the individual income tax. For example, if the corporate income tax is 50 percent and a cash dividend of $15 is distributed to a shareholder in the 20 percent individual tax bracket, the shareholder reports a $30 dividend, which is taxed at 20 percent or $6. His total individual income tax is increased by the $6 and reduced by the $15 withholding tax--a net refund of $9 to the shareholder is effected through these transactions. Any corporate income not distributed is, of course, taxed at the flat rate of 50 percent, under the assumptions given.

Both the dividends paid deduction method and the withholding method (in their pure forms, as described above) tax distributed corporate income to shareholders without any double taxation (or overtaxation) of distributed corporate income. Neither method, however, necessarily taxes corporate income to shareholders when it is earned by the corporation. As compared with the partnership method, the major shortcoming of these methods is that they do not tax undistributed corporate income to shareholders. Both are simple to apply from an administrative and compliance standpoint; however, the withholding method is easier to enforce in terms of collecting the tax, whereas the

dividend paid deduction method probably is easier for taxpayers to understand. Of the two methods, the withholding method is generally favored because it would interfere less with corporate dividend policies. The dividend deduction method would exert considerable pressure on corporations to distribute income.

Dividend received credit method. Under this method, the corporate income tax is retained, but individuals who receive dividends are permitted to offset a certain percentage of dividends received against the individual income tax. Depending upon the percentage of dividends permitted as a tax credit, this method provides various degrees of relief from the double taxation (or overtaxation) of distributed corporate income. However, this method, like the two preceding methods, does not integrate the taxation of undistributed corporate income. In addition, this method has one significant defect that is not possessed by the two preceding methods--as individual income rises, the dividend credit removes an increasing portion of the additional burden of the corporate tax on distributed corporate income. To illustrate this point, assume $100 of corporate income (before any tax) is to be distributed to an individual in the 20 percent individual tax bracket and that the corporate income tax is 50 percent. Without the corporate income tax, the shareholder pays $20 in taxes (20 percent of $100).

With the corporate income tax, the shareholder pays $60 ($50 corporate tax plus 20 percent of the $50 dividend). The additional burden of the corporate tax to this individual is $40 ($60 - $20). A 10 percent dividend credit removes 12-1/2 percent ($5/$40) of the additional burden of the corporate tax. The same procedure will show that the 10 percent dividend credit removes 25 percent of the additional burden for an individual in the 60 percent bracket ($5 credit over $20 additional tax).

According to the House Ways and Means Committee Report that accompanied the 1964 Revenue Act, the 4 percent dividend credit (which was in effect from 1954 to 1964) was repealed for the following reasons: (1) the credit failed to provide a satisfactory offset to the double taxation of dividend income because of the defect illustrated above; (2) reductions in corporate and individual tax rates that were to be enacted in 1964 would provide more relief from double taxation than the dividend credit; and (3) the dividend credit had failed to stimulate equity investment.[1]

Exclusion of dividends from the individual normal tax but not the surtax (a method used from 1913 to 1936) is a

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[1]U. S. House, Committee on Ways and Means, Revenue Act of 1964 H. Rept. 749, 88th Cong., 1st Sess., C.B., 1964-1, pp. 156-57.

variation of the dividend received credit method.[2] The normal or base rate becomes, in effect, the percentage used as a dividend credit. However, basing provisions on differences between individual normal and surtax rates is presently an obsolete practice.

Dividend exclusion method. Under this method, the corporate income tax is retained and some flat amount of dividends received is excluded from the individual income tax. From 1954 to 1964, $50 of dividends could be excluded annually, from 1964 to the present, a $100 exclusion has been permitted ($100 and $200, respectively, for joint returns). The exclusion and credit were combined between 1954 and 1964 as a means of providing additional tax relief for shareholders in low individual tax brackets.[3]

The dividend exclusion is clearly an unsatisfactory method of integrating the taxation of distributed corporate income. Regardless of the amount of the exclusion, there is no way the dividend exclusion can coordinate effectively the corporate income tax and the progressive individual income tax--exclusion of a flat amount of dividends is coordinated with neither the amount of dividends received nor the

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[2]The Federal Tax System: Facts and Problems 1964, op. cit., p. 59.

[3]Ibid., pp. 59-60.

individual tax bracket of the recipient. The $100 exclusion must be regarded as being mainly a token device for relieving the double taxation of distributed corporate income.

Dividends plus change in market value. This method requires that shareholders report as personal income dividends received plus change in the market value of their stock. Although this method could be used either with or without a separate corporate income tax, the general theme of integration suggests that little or no separate corporate income tax be imposed.

On first impression, this method has considerable appeal as an approach to taxing shareholders of publicly held corporations. These shareholders usually figure the return on their investment in terms of dividends plus change in the market value of their stock. Moreover, this method is based upon recognition of (1) the separation of ownership and control of publicly held corporations and (2) the fact that changes in stock values are not necessarily related to the amount of corporate income retained.

In terms of financial theory, this method has been opposed in that it would involve taxing increases in stock values which are based on expected increases in dividends and then taxing the increases in dividends again when they are realized--another form of double taxation. This method has also been opposed on practical grounds. The absence of

a cash flow to pay the tax on unrealized (or paper) gains may cause hardship and force some shareholders to sell their stock. In addition, effective application of this method requires reliable and readily determinable market values. Less than two percent of business corporations have stock that is listed on national or regional exchanges or traded actively over-the-counter (see Chapter VI).

Summary. All of the principal methods of integrating the taxation of corporate income, within the general framework of the federal income tax system, are described above. These methods are described in terms of their pure form; various combinations and modifications of these methods could be used. However, combination and modification of these methods, in general, neither adds to their attributes, nor corrects their defects.

The partnership method, which is suitable only for closely held corporations, is the only complete method of integration. Except for the partnership method and the dividends plus change in market value method, all of the other integration methods deal exclusively with distributed corporate income. Of the latter group, the withholding method is generally considered the best method.

Integration and Closely Held Corporations

Application of any of the integration methods, other than the partnership method, to closely held corporations would do little to provide a more equitable means of taxing these corporations. Obviously the dividends plus change in market value method is out of the question; there is no active market for the stock of these corporations. The dividends paid deduction method and the withholding method, which are the only methods worth considering, would change the effective tax burden of shareholders of closely held corporations only to a minor extent. As explained in Chapter II, shareholders of closely held corporation, as a general rule, arrange to make the bulk of corporate income distributions in the form of expense payments to themselves (salaries to officer-shareholders, etc.), which are deductible in computing the taxable income of corporations. Thus, there is very little double taxation which could be removed by either of these two methods. In addition, these methods would contribute little or nothing to the elimination of the problem of closely held corporations retaining corporate income to avoid higher personal income taxes at the shareholder level. On the other hand, mandatory application of the partnership method would eliminate both problems. The partnership method, as applied to closely held corporations, is examined in the remaining chapters of this study.

Integration and Publicly Held Corporations

Although an examination of the desirability of integrating the taxation of publicly held corporations is beyond the scope of this study, a few general observations on why the taxation of these enterprises has not been integrated to any significant extent are in order. Much of the inactivity in this area can be attributed to: (1) conceptual problems involved in determining the need for integration--including the separate entity viewpoint, capitalization of the corporate income tax, and the uncertain incidence of the corporate tax; (2) the reduction in tax revenue that would result from extensive integration; and (3) various political factors.

Separate economic entity viewpoint. One eminent tax authority has compared private and public corporations with respect to the appropriateness of integration as follows:

> The typical small private corporation is in important economic respects closely similar to a partnership. In taxing such corporations, it may be more reasonable to look to the economic identification of the corporation and its stockholders than to their legal separateness. . . .
>
> The typical large public corporation, on the other hand, is very different from a partnership. It can be held to be essentially analogous to a partnership only by extreme abstraction from the institutional realities of a going concern. Less strain on the imagination is involved in the legal assumption that the stockholders and the corporation are entirely separate. The facts seem to suggest a close community of economic

> interests rather than either complete identity or complete separation.
>
> Taxing both the profits of the public corporation and the dividends received by its stockholders does not seem to be so much double taxation of the same income as separate taxation of the incomes of two related economic entities. Similarly, failure to include the undistributed profits of the public corporation in the taxable income of its stockholders may be justified.[4]

Thus, some individuals believe the economic separation of shareholders from publicly held corporations warrants a non-integrated approach to taxing these corporations. On the other hand, many students of taxation maintain that it is nonsense to state that the same income can be both income of the corporation as a separate entity and income of shareholders. Different views of the nature of publicly held corporations have led to many disagreements over the need for integration.

Capitalization of the corporate income tax. The corporate income tax paid by publicly held corporations is capitalized in the market value of their stock. Shareholders buy the stock net of the corporate income tax. Thus, only shareholders who hold the stock during periods in which the corporate income tax is increased (or during periods in which an increase in anticipated) bear the corporate tax. Many

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[4]Goode, The Corporation Income Tax, op. cit., p. 25.

individuals who have adopted this point of view maintain that there is little need to eliminate the double taxation of income of publicly held corporations, since stock prices have already been adjusted for the corporate tax.

Incidence of the corporate income tax. For over fifty years, there has been substantial disagreement among economists on the extent to which the corporate income tax is borne by shareholders, shifted forward in the form of higher prices to consumers, or shifted backward in the form of lower wages and other factor payments. To the extent that the corporate income tax is shifted, the overtaxation (or double taxation) of distributed corporate income is reduced. The uncertain incidence of the corporate tax is another factor that has served amply to becloud thoughts on the need for integrating the taxation of publicly held corporations.

Reduction in tax revenue. From 1960 to 1965 the corporate income tax produced approximately one-third of federal income tax receipts and one-fourth of total federal tax receipts.[5] In 1964, 5,886 corporations had assets exceeding $25 million. This select group, which comprised less than one-half of 1 percent of business corporations, paid $19.7 billion in corporate taxes (70 percent of the total

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[5]The Federal Tax System: Facts and Problems 1964, op. cit., p. 206.

collected) in 1964. The same group paid cash dividends equal to 44 percent of the total net income of the group.[6] Elimination of any significant amount of double taxation of dividends paid by this group of corporations and other publicly held corporations would produce a substantial decrease in tax revenue.

In explaining the changes in 1964 in the tax treatment accorded dividends, the House Report noted:

> Your committee concluded that it would be better to concentrate relief from any double taxation which it is possible to provide in a dividend exclusion rather than in a dividend credit . . . removing the credit even though doubling the exemption available has the effect of raising $300 million of revenue in the calendar year 1965 and subsequent years, which your committee has devoted to further individual income tax rate reductions than would otherwise be possible.[7] (Italics mine.)

In view of statements such as the above, it is easy to understand why Congress has shown little interest in adopting either the withholding method or the dividend deduction method of integration: extensive use of either method would reduce tax revenue by several billion dollars.

Political Factors. Integration for publicly held corporations would necessarily involve a reduction in the double

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[6] Statistics of Income, 1964, Corporation Income Tax Returns (Preliminary) op. cit., p. 30.

[7] Revenue Act of 1964, H. Rept. 749, op. cit., p. 157.

taxation (or overtaxation) of distributed corporate income. From a political viewpoint, this means that tax relief would be provided for either "big business" on the one hand or "wealthy shareholders" on the other, depending on how one looks at the issue. It is common knowledge that many, if not most, voters are not sympathetic to the tax relief needs of either, especially when such tax relief is likely to be accompanied by a tax increase for the "little man."

In the President's 1963 Tax Message (which recommended repeal of the dividend credit), considerable emphasis was given to statistics showing that most of the stock of publicly held corporations that is not owned by institutions is owned by individuals in upper-middle or high income brackets.[8] Also, the close relationship between monopolistic business practices and big business has been mentioned frequently in Congressional hearings on corporate income taxation.

To summarize, the combination of conceptual problems involved in determining the need for integration, tax revenue requirements, and various political factors have militated against integrating, to a significant extent, the taxation of large, publicly held corporations.

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[8]U. S. House, President's 1963 Tax Message, Hearings before the Committee on Ways and Means, 88th Cong., 1st Sess., Part 1, pp. 263-69.

Further consideration of the problems peculiar to publicly held corporations is beyond the scope of this study. The mandatory partnership tax system considered in this study could be used for closely held corporations, in conjunction with either the present corporate income tax method, as applied to publicly held corporations, or the corporate tax method, as modified by one of the partial integration methods, such as the withholding method.

CHAPTER IV

OPTIONAL VERSUS MANDATORY PARTNERSHIP TAX TREATMENT

This chapter examines: (1) the background of Subchapters R and S, (2) tax treatment under these subchapters, and (3) the basic differences between optional and mandatory partnership tax treatment, with respect to equity, tax neutrality in small business form selection, and tax management.

Background: Studies and Recommendations

In 1938, the National Tax Association appointed a committee to investigate the need for general revision of the corporate income tax structure, with particular regard to the taxation of undistributed corporate income. In 1939, the committee issued its final report; the principal findings and recommendations of the committee were as follows:

> During the last twenty-five years the progressive personal income tax has become the cornerstone of the federal revenue structure. It is the most accurate and delicate fiscal instrument yet devised for fixing the

> tax liability of individuals with justice, as expressed in terms of relative ability-to-pay. . . .[1]
>
> . . . our committee recommends that, in the effort to reach corporate profits for personal income tax purposes the use of the partnership method should be extended to the limits of its legal and administrative possibilities. However, considerable difference of opinion exists regarding what these limits are.[2]
>
> We know, for instance, that there are corporations that are really partnerships or individual proprietorships merely encrusted with a corporate charter. These are so-called close corporations. At the other extreme, we have the large public corporations that have little or no resemblance to partnerships. Where a close corporation ends and a public one begins is difficult to determine and the committee has not attempted to lay down a definite line of demarcation. But the important point for present purposes is to recognize that the line between a close corporation and its owner is shadow, whereas with the public corporation it is substance.
> . . . in respect to close corporations, they would be treated for tax purposes like what they really are--a partnership of individuals.[3]

The above is the most significant endorsement of mandatory partnership tax treatment for closely held corporations that has ever been presented. This committee was unable to reach substantial agreement on how large, publicly held corporations should be taxed. Priorities of World War II

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[1]"Final Report of the Committee on Federal Taxation of Corporations," Proceedings of the Thirty-second Annual Conference, National Tax Association (1940), p. 539.

[2]Ibid., p. 555.

[3]Frank E. Seidman (member of the committee) "Comments on Committee Report," Proceedings of the Thirty-second Annual Conference, National Tax Association (1940), p. 602.

precluded any immediate follow-up on the committee's recommendations.

Examination of the need for general revision of the corporate tax structure was resumed during the postwar period. Although a formal committee on corporate income taxation was not appointed by the National Tax Association during this period, several members of the Association presented papers which were discussed at a few panel sessions sponsored by the Association and other organizations.[4] The majority of participants in these discussions agreed that the taxation of corporations, in general, as separate entities could not be justified in principle; however, there was substantial disagreement on the type of revision that would be the most appropriate. Much of the discussion centered around the desirability of adopting one of the four basic methods of integration discussed in Chapter III--partnership method, dividend paid deduction method, withholding method, and the dividends received credit method.

The positions taken by the majority of participants in the postwar discussions and by the National Tax Association Committee in 1939 agreed on two major points: (1) There is

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[4]For papers and discussions during the postwar period, see: National Tax Association, annual proceedings, 1946 & 1947; How Should Corporations Be Taxed, (New York: Tax Institute, Inc., 1946); and U. S. House, Committee on Ways and Means, Hearings on Revenue Revisions 1947-48, Section: Corporation Tax Problems and General Revisions, 80th Cong., 1st. Sess., 1947.

no overall, feasible solution to revising the tax treatment accorded all corporations to bring it into line with the ability to pay of shareholders, because the partnership method of integration, which is the only complete method, is not suitable for large, publicly held corporations. (2) One of the most deplorable aspects of taxing corporations as separate entities is that small, closely held corporations, which differ from unincorporated business enterprises only in legal formalities, are accorded substantially different tax treatment.

Although both the 1939 committee and the postwar participants were concerned principally with finding an equitable and practical approach to taxing corporations in general, the focus of the two groups differed somewhat. During the prewar period, primary consideration was given to the problem of corporations retaining a high percentage of their income to reduce personal income taxes of shareholders (or the undertaxation of undistributed corporate income). During the postwar period, on the other hand, primary consideration was given to the problem of overtaxation (or double taxation) of distributed corporate income.

This change in emphasis resulted from the steep increases in both corporate and individual tax rates during World War II; postwar tax rates were approximately double

what they were in 1939.[5] Tax relief, as well as equity, received considerable attention during the postwar period. It was somewhat natural for the emphasis to shift from (1) the undertaxation of undistributed corporate income--a problem of equity, but not a problem requiring tax relief to (2) the overtaxation (or double taxation) of distributed corporate income--a problem of equity and a problem calling for tax relief.

Emphasis on tax relief resulted in optional, rather than mandatory, partnership tax treatment for closely held corporations receiving the only serious consideration during the postwar period. Presumably, optional partnership tax treatment would be used only when it would lower the tax burden of shareholders. On the other hand, mandatory treatment would lower the tax burden of shareholders of some closely held corporations and increase the tax burden of others. Emphasis on tax relief is evident in the following excerpts taken from three papers presented during this period:

> We could come much closer to equality in taxing small corporate and noncorporate concerns if we permitted small concerns to be taxed as partnerships, when it

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[5]The top corporate rate was 19 percent in 1939 and 38 percent in 1947. Individual rates ranged from 4 to 79 percent in 1939 and from 19 to 86.45 percent in 1947. The Federal Tax System: Facts and Problems 1964, op. cit., pp. 233, 265.

is advantageous, and allowed proprietorships and partnerships to be taxed as corporations.[6] (Italics mine.)

. . . an optional use of the partnership method by small corporations would provide some tax relief to many small corporations. . . . A compulsory application . . . would actually increase tax burdens on a great many small corporations. . . . But I do not believe any serious consideration need be paid to a compulsory application of the partnership method. . . . Since the method cannot be applied to all corporations, it can hardly be applied on a compulsory basis to small corporations on many of whom it would impose extremely severe tax burdens.[7]

Although there have been proposals both for mandatory and for optional partnership treatment of certain types of corporations, the present discussion approaches the matter from the standpoint of a tax-relief measure and concentrates attention on the optional partnership treatment. The objective of an option for certain corporations to be taxed like partnerships would be to give such corporations and their stockholders the opportunity of paying no more tax than owners of unincorporated enterprises on both distributed and undistributed profits. . . . In contrast to the optional or tax-relief approach, the mandatory partnership method could also prevent tax avoidance or postponement with respect to earnings retained in corporations owned by stockholders subject to individual income tax rates higher than the corporate rates.[8]

The general issues involved in adopting a mandatory or

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[6]Alfred G. Buehler, "Some Comments on the Taxation of Small Business," Proceedings of the Thirty-ninth Annual Conference, National Tax Association (1946), p. 417.

[7]J. Keith Butters, "Would the Complete Integration of the Corporate and Personal Income Taxes Injure Small Business?" Proceedings of the Fortieth Annual Conference, National Tax Association (1947), pp. 190-91.

[8]U. S. Treasury Department, Division of Tax Research, Taxation of Small Business, 1947, reprinted in: U. S. House, Committee on Ways and Means, Hearings on Revenue Revisions 1947-48, 80th Cong., 1st Sess., 1947, pp. 3757-58.

optional partnership approach are examined in the latter part of this chapter. The Treasury Department study above contained no policy recommendations with respect to partnership tax treatment for closely held corporations. This study merely evaluated the optional proposal as a tax relief device and noted that if the option were adopted, simplified partnership tax rules should be used to avoid excessive compliance problems.

The lack of an overall, feasible solution to the integration problem and the contention that something should be done about removing the differences in tax treatment between small, closely held corporations and unincorporated business enterprises prompted the Eisenhower Administration to include among its recommendations for tax reform in 1954: (1) a dividend received credit for corporations in general (discussed in Chapter III) and (2) optional alternative tax treatments for certain small business enterprises.[9]

According to the President's budget message of January, 1954: "small business should be able to operate under whatever form of organization is desirable, for their particular circumstances, without tax penalties." In pursuit of this

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[9]U. S. Treasury Department. The Budget of the United States Government for the Fiscal Year Ending June 30, 1955. (Washington, D. C.: Government Printing Office, 1954), p. M20.

objective, the Administration recommended "that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations.[10]

In response to the Administration's recommendations, two of the amendments added by the Senate Finance Committee to the bill that was to become the 1954 Internal Revenue Code provided for optional tax treatments. Section 1351 of the bill gave certain closely held corporations the option to be taxed as partnerships, with certain exceptions. Section 1361 gave certain proprietorships and partnerships the option to be taxed as corporations, with some exceptions.[11] Only the latter option survived the Conference Committee; no explanation was given in the various Congressional reports as to why the former option was stricken from the bill. In 1961, Sheldon Cohen, the present Commissioner of Internal Revenue, said that the drafting problems were too difficult to solve in the short period available before the end of the Congressional session.[12] The amendments were introduced late

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[10] Ibid.

[11] U. S. Senate, Committee on Finance, Internal Revenue Code of 1954, S. Rept. 1622, 83rd Cong., 2nd Sess., 1954, p. 72.

[12] Sheldon S. Cohen, "Relationship Between Provisions of Subchapter S and Subchapter C," Proceedings of the New York University Annual Institute on Federal Taxation, XX (1962) p. 827.

in the session and the entire 1954 Code was being drafted at the time.

The provision giving certain proprietorships and partnerships the option to be taxed like corporations became Subchapter R of the Code. In 1958, Congress enacted Subchapter S, which gives certain closely held corporations the option to be taxed somewhat like partnerships. The Senate Finance Committee Report that accompanied the enactment of Subchapter S stated:

> Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences. In this respect, a provision to tax the income at the shareholder, rather than the corporate level, will complement the provision enacted in 1954 permitting certain proprietorships and partnerships to be taxed like corporations. Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business.[13]

Subchapter R

At the present time, Subchapter R is a semi-obsolete provision. In 1966, legislation was enacted to repeal Subchapter R, effective January 1, 1969. Only unincorporated enterprises that had elected Subchapter R treatment prior to

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[13]U. S. Senate, Committee on Finance, Technical Amendments Act of 1958, S. Rept. 1983, 85th Cong., 2nd Sess., C.B. 1958-3, p. 1008.

April 14, 1966, may use the option until 1969. In the meantime, electing enterprises may revoke their elections.[14] Repeal of the provision was explained by the Senate Finance Committee Report as follows:

> The latest available Internal Revenue Service statistics indicate that there are probably fewer than 1,000 business entities which have elected this corporate option. Your committee has concluded that a provision of this complexity which has proved to be of such limited usefulness should not be continued.[15]

Among the principal reasons Subchapter R has been used by comparatively few unincorporated business enterprises are the following:

1. For a business to qualify under this subchapter, either (a) capital must be a material income producing factor or (b) 50 percent or more of the gross receipts of the business must be derived from trading as a principal or from buying and selling real property, stock, securities, or commodities for the account of others.[16] Thus, most firms offering professional services such as law, accounting, medicine, and engineering did not qualify for the election. In general, professional firms are the only group of firms that

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[14]U. S. Senate, Committee on Finance, Subchapters S and R of Chapter 1 of the Internal Revenue Code of 1954, S. Rept. 1007, 89th Cong., 2nd Sess., 1966, pp. 9-12.

[15]Ibid., p. 9.

[16]I.R.C. (1954), sec. 1361(B)(4). (before repealed)

local laws and various codes of professional ethics prohibit from incorporating. Since other firms may be incorporated without similar restrictions, the option served a rather limited function.

2. Under Subchapter R, most forms of personal holding company income (dividends, interest, etc.) are taxed directly to the owners, rather than to the business entity.[17] This limited the appeal of the election to individuals in high tax brackets, who are the only persons in a position to realize substantial tax savings by switching to the corporate tax method.

It is somewhat apparent why the rules in (1) and (2) are contained in Subchapter R: Congress has had no desire to expand opportunities for using the corporate tax method for personal holding company purposes, either for personal-service income or investment-type income.

3. Prior to the repeal of Subchapter R, the election was irrevocable as long as the enterprise remained unincorporated, unless the electing owners' interests in profits or capital dropped to 80 percent or less of what they were at the time of the election.[18] Thus, election of Subchapter R could result in a considerable loss of flexibility with respect to future tax management.

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[17] I.R.C. (1954), sec. 1361 (i).

[18] I.R.C. (1954), sec. 1361 (e), (f).

4. One of the principal advantages of the corporate tax method, the use of certain employee fringe benefits and pension and profit-sharing plans by officer-shareholders, was not permitted under Subchapter R.[19] This rule probably was included to avoid having unincorporated business enterprises use the election for this purpose only--i.e., by electing Subchapter R treatment and then draining the corporation of taxable income through expense payments to shareholders.

In brief, with the exception of a few special cases, there was no reason for those enterprises that could incorporate to use the option when the full benefits of the corporate tax method could be realized by incorporating. On the other hand, most businesses that could not incorporate (e.g., professional groups) were not permitted to use the option. To a large extent, Congress attempted, under Subchapter R, to provide corporate tax treatment but, at the same time, restrict the use of corporate tax treatment for purposes of avoiding personal income taxation. The result was the creation of a somewhat useless provision that has caused many administrative and compliance problems in the few cases in which it has been used.

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[19] I.R.C. (1954), sec. 1361 (d).

Subchapter S

Summary of Major Features[20]

Initial eligibility. To qualify for the election, which applies only to "small business corporations", a corporation must satisfy the following requirements: (1) be a domestic corporation which is not a member of an affiliated group; (2) have ten or fewer shareholders, all of whom are individuals or estates and none of whom are nonresident aliens; and (3) have only one class of stock outstanding. In general, an affiliated group of corporations consists of a parent owning 80 percent or more of each of one or more subsidiaries. For purposes of the ten-shareholder limit, stock owned as community property of a husband and wife, or held by them as joint tenants, tenants by the entirety, or tenants in common is treated as owned by one shareholder.

Election. For a "small business corporation" to exercise the Subchapter S option, all the shareholders must consent to the election. An election form containing the signatures of the shareholders must be filed within one month before or after the beginning of the taxable year for

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[20]This summary was abstracted from: I.R.C. (1954), Subchapter S, secs. 1371-78 and C.F.R. 1.1371-78. Individual footnotes are not provided in this section to avoid an excessive number of references to the Code and the Treasury Regulations.

which the election is desired. Once a valid election has been made, the election remains in effect for subsequent years unless the election is revoked by the shareholders or terminated because of a disqualifying act. For any taxable year after the first, the election may be revoked if all the shareholders consent to the revocation. To be effective for any taxable year, a revocation must be made before or during the first month of that year.

An election will be terminated for the taxable year (and for subsequent years) in which any one of the following disqualifying acts occurs: (1) a new shareholder fails to file a written consent to the election within one month of stock acquisition; (2) stock is transferred to a trust, corporation, or any other ineligible shareholder; (3) the corporation issues a second class of stock; (4) the corporation derives more than 80 percent of its gross receipts for the taxable year from sources outside the United States or more than 20 percent from "passive investment income," which includes dividends, rent, interest, and similar income.

Once an election has been revoked or terminated, the corporation (and any successor) may not make another election under Subchapter S for five years. The Internal Revenue Service, however, has certain discretionary powers to reduce the five-year waiting period in cases involving extenuating circumstances.

Effect of an election. For any year in which the election is in effect, the corporation is not subject to the corporate income tax--the income of the corporation is taxed directly to the shareholders. In general, shareholders report as taxable income dividends received plus their pro-rata share of the undistributed taxable income of the corporation. Neither actual nor constructive dividends are eligible for the $100 dividend exclusion, since there is no double taxation of this income. In the allocation of taxable income to shareholders, only long-term capital gain retains its original source characteristic; any other income is treated as ordinary income. If the corporation incurs a net operating loss, the loss is allocated to the shareholders, who may offset this loss against other personal income in the current year and carry the excess, if any, back or forward to other years, according to the rules applicable to net operating losses incurred by individuals. Income which has been taxed, but not distributed, to shareholders is not taxed again when the income is subsequently distributed.

The basis of a shareholder's stock in a Subchapter S corporation is increased by the amount of undistributed taxable income included in his personal income and reduced by (1) dividends paid out of income taxed to the shareholder in previous years but not distributed and (2) net operating

loss allocations to shareholders. The basis of a shareholder's stock plus any corporate debt he may hold cannot be reduced below zero--loss in excess of the combined bases is forfeited.

The taxable income of a Subchapter S corporation is computed in essentially the same manner as that of a regular corporation. However, deductions for dividends received from other corporations and for net operating loss carry forwards from non-Subchapter S years are not permitted. The 85-percent dividend deduction is not permitted because dividends received by a Subchapter S corporation are not taxed at the corporate level. Operating losses incurred in non-Subchapter S years are the corporation's and may be used only when the regular corporate tax method is used. Likewise, operating losses incurred when the election is in effect belong to shareholders. The two are kept separate.

In the event the election is revoked or terminated, the corporation and the shareholders are subject to regular corporate tax provisions for the year of termination and for subsequent years. Adjustments are, however, made for distributions of income taxed, but not distributed, during Subchapter S years. These distributions are not taxed again to shareholders after the election has been terminated. A complex set of rules must be applied to

determine the source of corporate distributions.

Analysis of Subchapter S

Number of Subchapter S corporations. In 1964, 157,855 corporations filed under Subchapter S. The percentage of the total number of corporations using the Subchapter S option increased steadily from 8 percent in 1960 to 12 percent in 1964. Although the number of business organizations using the Subchapter S option increased at a faster rate from 1960 to 1964 than the number of businesses using any other organizational (tax) form, Subchapter S corporations still comprised less than 2 percent of the business population in 1964, as shown in Table 1 (next page).

Size of Subchapter S Corporations. The vast majority of Subchapter S Corporations are small businesses. Of the 139,112 Subchapter S corporations in 1963; 138,232 had assets totaling less than $1 million; 877 had from $1 million to $10 million; and 3 had $10 million or more.[21] Only 1,164 Subchapter S corporations had net income of $100,000 or more in 1962; 5 had net income of $1 million or more.[22] The rarity of large size follows principally from the shareholder

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[21]U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1963, Corporation Income Tax Returns, with accounting periods ended July 1963-June 1964, (Washington, D. C.: Government Printing Office, 1968), p. 255.

[22]Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., p. 280.

TABLE 1

NUMBER OF BUSINESS ORGANIZATIONS
BY FORM OF ORGANIZATION[a]

Year	Subchapter S Corporations	All Corporations	Partnerships	Proprietorships
1960	90,221	1,140,574	940,560	9,089,985
1961	106,048	1,190,286	938,966	9,241,755
1962	123,666	1,268,052	932,181	9,182,586
1963	139,112	1,323,187	924,276	9,135,954
1964	157,855	1,373,517	922,160	9,192,746

[a]Source: U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1964, U. S. Business Tax Returns, with accounting periods ended July 1964-June 1965, (Washington, D.C.: Government Printing Office, 1967), pp. 122-28.

limit of ten; there are no financial-size limitations (on assets, income, etc.) involved in qualifying for the Subchapter S election.

Neutrality in small business form selection. Subchapter S provides tax neutrality for small business form selection only insofar as it gives individuals an opportunity to select the corporate form and be taxed somewhat like they would have been if they had selected an unincorporated form. In this respect, Subchapter S provides tax neutrality primarily for individuals in low-middle to low tax brackets. Many individuals in high tax brackets select the corporate

form and use the corporate tax method for the principal purpose of minimizing their tax burden. Since individuals in low tax brackets can, under the corporate method, by-pass the corporate tax by draining the corporation of taxable income, Subchapter S makes a rather limited contribution to tax neutrality in small business form selection.

As a tax relief measure. Shareholders in tax brackets lower than those applicable to corporate income who are not allowed to drain all the income out of the corporation (through salaries, interest, etc.) may reduce their tax burden by making a Subchapter S election. Also, shareholders in tax brackets slightly higher than the effective corporate rate may reduce their tax burden by a Subchapter S election, if a significant amount of corporate income is being distributed as dividends.

Either complete draining of corporate income (which is not always easy to arrange) or the Subchapter S election will serve to by-pass the corporate income tax entirely. However, since draining is subject to possible litigation (salaries treated, in part, as dividends, etc.), the Subchapter S election is the safer of the two routes. Moreover, in draining corporate income, long-term capital gains realized at the corporate level are converted into ordinary income (salaries, etc.) at the shareholder level. By using the Subchapter S election, this kind of conversion can be

avoided.

Under the corporate income tax method, a net operating loss in any year may be carried back three years and forward five, as an offset against taxable income. Losses not utilized during the eight year period are forfeited. For corporations incurring losses for several consecutive years, there exists the possibility that a substantial portion of the losses will be forfeited due to a lack of taxable income, a situation not uncommon among new corporations.

Under the Subchapter S election, net operating losses are passed through to shareholders, who may offset these losses against other personal income. This reduces the possibility of forfeiture and permits current utilization of operating losses. Subchapter S makes a significant contribution in this area because there is no way to siphon off losses in the same way a corporation may be drained of taxable income.

The pass-through of operating losses may be beneficial to individuals in high or low tax brackets; however, since individuals in high tax brackets are the persons who usually have substantial amounts of other personal income, the pass-through is, in many cases, considerably more beneficial to them. Moreover, use of Subchapter S during loss years and the corporate tax method during profitable years (within

limits prescribed by the Code) may be particularly beneficial for shareholders in high tax brackets.

Problems Encountered under Subchapter S

Prior to his appointment as Commissioner of Internal Revenue, Mortimer Caplin made the following observations with respect to Subchapter S:

> . . . subchapter S fails to meet its limited stated purpose. S shareholders are not taxed like partners, and tax planners, who typically were limited to partnership-versus-corporation considerations, now make a tripartite analysis in determining the optimum tax results: partnership-versus-corporation-versus-subchapter S. The differences in tax consequences can be "major" and the tax-savings possibilities startling.
>
> In addition, chiefly due to its divergence from partnership taxation, subchapter S is fast becoming an important "tax gadget." Already, it has been widely publicized as a patented cure-all for a wide variety of serious tax ailments: for family income-splitting and for "employee" fringe benefits, for accumulated earnings and for personal-service personal holding companies, for collapsible corporations and for borderline partial liquidations--in fact, for any liquidation not otherwise assured of a single capital gain.
>
> Aside from manifesting many policy conflicts with other sections of the Code, subchapter S is also a sophisticated and complex provision. A full understanding of its operation demands knowledge not only of its novel terminology, but also of the refinements of taxing individuals, corporations, as well as partnerships. Comparison of each of these systems of taxation must be made if subchapter S is to be used intelligently.
>
> In short, subchapter S has a Lorelei-like quality which can easily entrap the uninitiated. It contains unexpected quirks and reflects dubious policy distinctions.[23]

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[23]Mortimer M. Caplin, "Subchapter S vs. Partnership: A Proposed Legislative Program," Virginia Law Review, XLVI (January, 1960), pp. 61-62.

Although Mr. Caplin's observations may overstate the case against Subchapter S, they provide a good summary of some of the major problems encountered under this provision. An explanation of some of the major problems is presented below.

Tax planning: increased complexity. With respect to Subchapter S, the Senate Report states that special rules, rather than those contained in Subchapter K (the regular partnership system), were adopted in order that the provision could "operate in as simple a manner as possible."[24] To a large extent, Congress has attempted to provide partnership tax treatment within the constraints of the corporate tax system; most of the rules pertaining to Subchapter S operations are regular corporate tax rules.

Among the principal areas in which there are significant differences between Subchapters S and K are: (1) The extent of conduit tax treatment employed: Under Subchapter S, only net long-term capital gain retains its source characteristic. Under Subchapter K, every kind of receipt or deduction that is subject to special handling in the determination of individual tax liability must be passed through separately to partners; there are more than 10 of these items. (2) Treatment of owners as employees: Under

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[24]Technical Amendments Act of 1958, S. Rept. 1983, op. cit., C.B. 1958-3, p. 1009.

Subchapter S, officer-shareholders are considered employees, eligible to participate in certain penion, profit-sharing, and other fringe benefit plans which are not available to partners under Subchapter K. (3) Timing of taxable income: Allocations of income and losses pertaining to ownership transfers during the taxable year and freedom to select or change taxable years differ between the two subchapters. (4) Ownership redemptions, liquidations, reorganizations: In general, Subchapter S follows regular corporate tax rules in these areas. Subchapter K, on the other hand, has its own set of rules. The major differences between these subchapters are examined in detail in Chapter VII.

In the main, the rules contained in Subchapter S are neither more nor less advantageous than those contained in Subchapter K. For the typical business that is to operate for an indefinite period under either Subchapter S or K, the differences in tax results are not likely to be significant, even though there are significant differences in the two sets of tax rules. Nevertheless, there are many situations in which the differences in these rules may produce significant differences in tax results. Since an informed tax adviser has to consider all these special situations, he must regard Subchapter S and Subchapter K as two separate forms of business organization for tax purposes. In this respect, Subchapter S has increased, rather than reduced,

tax considerations with respect to small business form selection.

Another tax planning problem added by Subchapter S is the potential loss of the Subchapter S election. Since transfer of stock to one non-consenting shareholder, or to a trust (perhaps one set up in a shareholder's will), or to a corporation, or to any other ineligible shareholder will terminate the election, control over stock transfers is crucial. Use of buy-out agreements and similar arrangements are an important aspect of Subchapter S tax management. A discontented minority shareholder, who has the power to terminate the election by the mere transfer of one share of stock, is certainly an unwelcome member of a Subchapter S corporation. On the other hand, many Subchapter S terminations are planned. Revocation must be made before or during the first month of the taxable year to be effective for that year. Termination, on the other hand, can be effected by a disqualifying act performed any time during the taxable year, retroactive to the beginning of the year.[25]

Subchapter S as a tax gimmick. By making it easier for small businesses to change forms and to shift back and forth between forms, Subchapter S has added a new dimension

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[25]I.R.C. (1954), sec. 1372 (e).

to tax manipulation. For example, a corporation on which the accumulated earnings tax appears likely to be imposed may use the Subchapter S election (temporarily) to avoid this tax--Subchapter S corporations are not subject to the accumulated earnings tax or the personal holding company tax. The accumulated earnings tax situation may arise where the amount of retained corporate income cannot be justified by current business needs and where there are no definite plans for expansion. Use of the Subchapter S election for a couple of years until current business needs increase or until plans for expansion crystallize (or can be made to appear that way) may result in the avoidance of the accumulated earnings tax. Indefinite use of Subchapter S would, of course, defeat the purpose of accumulating corporate income. The temporary increase in shareholder tax burden may, on the other hand, be less than the accumulated earnings tax.

For individuals in high tax brackets, the realization of a significant amount of long-term capital gain at the corporate level presents an interesting problem. The usual tax minimization pattern of these individuals is to accumulate income in the corporation to be taxed at lower corporate rates. However, under this pattern, long-term capital gain is taxed at the corporate level and the shareholder level assuming accumulated corporate income is subsequently

converted into capital gain at the shareholder level. Operation under either Subchapter S or K would avoid the double taxation of long-term capital gain. However, continuous operation under either of these systems would also result in ordinary income being taxed at higher rates and would, therefore, defeat the purpose of corporate accumulation. The problem: how to pass-through long-term capital gain, without at the same time passing through large amounts of ordinary income. The solution: a one-shot capital gain under Subchapter S.

Prior to 1966, the one-shot capital gain worked as follows: a corporation with large amounts of real estate or other property substantially appreciated in value and subject to long-term capital gain treatment could use the Subchapter S election for one year, sell the appreciated assets during that year, pass through the capital gain to shareholders, and then revoke the election the following year.

Evidence of this practice is provided by the composition of net income, as between ordinary income and net long-term capital gain, for corporations reporting under Subchapter S in 1962. The five corporations that had income in excess of $1 million had net long-term capital gain comprising 66 percent of their combined net income. Comparable figures are as follows: corporations with income from $500,000 to $1 million (11 corporations), 49 percent;

income from $250,000 to $500,000 (87 corporations), 34 percent. The percentage decreases to only 10 percent for corporations with income under $5,000.[26] With a ten-shareholder limit, close association between high corporate income and high shareholder income may reasonably be assumed.

To limit this abuse of Subchapter S, section 1378 was added to the Code in 1966. This section provides that corporations which use the Subchapter S election will be subject to a tax on capital gains realized at the corporate level under the following conditions: (1) the excess of net long-term capital gain over short-term capital loss exceeds $25,000 and also exceeds 50 percent of the corporation's taxable income; (2) corporate taxable income exceeds $25,000; and (3) the corporation did not use the election in the three preceding taxable years. New corporations which have operated continuously under Subchapter S for less than four years are not subject to this tax.[27] In addition to the capital gain tax, when imposed at the corporate level, shareholders must also pay a tax on capital gains received. This provision should restrict one of the tax-gimmick abuses of Subchapter S, the one-shot capital gain.

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[26] Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., p. 280.

[27] I.R.C. (1954), sec. 1378.

Mandatory Partnership Tax Treatment

Optional partnership tax treatment for closely held corporations is supported principally on the grounds that it provides (1) some tax neutrality in small business form selection and (2) some tax relief for small corporations. In both respects it makes a rather limited contribution--this is presently the case under Subchapter S, and it probably would be the case under an improved Subchapter S. Most of the major deficiencies of Subchapter S stem from its optional aspect, not from the differences between the tax rules contained in Subchapters K and S.

Mandatory partnership tax treatment for closely held corporations would, on the other hand, provide a far more sound approach to taxing closely held corporations than that provided by the existing system. The mandatory approach is supported principally by improvements with respect to (1) equity, (2) tax neutrality, and (3) certainty in tax determinations.

Equity. Horizontal equity, which calls for according similar tax treatment to persons in similar positions, is the most important requirement of equity in income taxation. Without this requirement, discussions of equity in income taxation would be, to a large extent, meaningless. Horizontal equity is fundamental to the widely accepted

ability-to-pay approach to taxation, which requires that persons with equal ability pay equal taxes and those with unequal ability pay unequal taxes.[28]

In Congressional hearings in 1954, the American Institute of Certified Public Accountants (American Institute of Accountants, then) presented the following statement in recommending optional partnership tax treatment for closely held corporations:

> A major inequity in the present Federal tax structure results from the manner of taxing closely held corportaions. . . .
>
> With the exception of the difference as to limited liability, closely held corporations are, in fact, substantially the same as partnerships. Generally, the controlling stockholders act as partners in operating the business and have authority as to the distribution of profits similar to that of partners. In view of this, it appears unreasonable to tax closely held corporations on a basis different from that used in taxing partnerships. To tax these two types of business entities on a different basis results in taxation based on form rather than on substance. Such a situation is undesirable.[29]

Although not specifically stated, the above argument is, in the main, based on the principle of horizontal equity, with shareholders of closely held corporations and partners viewed as individuals in similar positions. This argument has been

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[28]Musgrave, op. cit., p. 160.

[29]Statement of the American Institute of Accountants, Topic 29, Partnerships. U. S. House, Hearings before the Committee on Ways and Means concerning General Revenue Revision, 83rd Cong., 1st Sess., 1953, Part 2, p. 1391.

used in most of the major proposals for partnership tax treatment for closely held corporations, whether optional or mandatory. In this connection, it is somewhat beyond the comprehension of this writer how students of taxation can use horizontal equity to support optional partnership tax treatment, without at the the same time stating why mandatory partnership tax treatment cannot or should not be employed. When A and B are in similar positions, horizontal equity does not call for offering B tax treatment similar to that provided A only when B cannot find a better deal tax-wise; this is precisely what optional partnership tax treatment does, with the corporate tax method comprising the better deal for shareholders in high tax brackets. The mandatory approach avoids this kind of inequity.

Of course, mandatory application of the corporate income tax method (or any other method) to all closely held business enterprises, whether incorporated or unincorporated, would also satisfy the requirement of horizontal equity as between their owners. However, it would not satisfy the principle of ability to pay, which is also an important principle. Only mandatory partnership tax treatment will satisfy both the principle of horizontal equity as between owners of closely held business enterprises and, at the same time, bring the taxation of closely held corporations

into conformity with the standard of ability to pay, as reflected in the individual income tax system.

Neutrality in business form selection. Adoption of a mandatory partnership tax system for closely held corporations would bring about a substantial improvement in tax neutrality associated with the selection of a legal form of organization for conducting a small business. The present choice of tax consequences associated with the corporate tax method, Subchapter S, and Subchapter K is markedly lacking in neutrality. Under the mandatory partnership system, the choice would be limited mainly to Subchapter K and the partnership tax system used for closely held corporations. There would be no opportunity to use the corporate form to shield income from taxation to its owners.

Nothing has been said so far about the differences between the tax treatment accorded proprietorships and partnerships; there are a few significant differences in this area. However, Subchapter K is, in the main, a system for treating a business entity as an association of individuals (or proprietors) for tax purposes. The major problems involved in establishing uniform tax rules for proprietorships, partnerships, and closely held corporations are examined in Chapter VII.

Certainty in tax determinations. Mandatory partnership tax treatment for closely held corporations would reduce

substantially the capriciousness, arbitrariness, and litigation that presently characterize the taxation of closely held corporations under the corporate tax method. Under a mandatory partnership tax system, all the income or loss of closely held corporations would be allocated to the owners. Thus, under this system, current distribution versus accumulation of income in the corporation; dividends versus distributions of income as salaries, interest, and rent paid to shareholders; and use of a single corporation versus splitting of income through the use of multiple corporations would produce little or no differences in tax consequences. These problems are not encountered, to any significant extent, under either Subchapter K or Subchapter S. However, Subchapter S makes a rather limited contribution in this area in that only 12 percent (as of 1964) of business corporations use this option. Also, the switching back and forth between tax forms which is possible under Subchapter S creates another form of capriciousness in tax determinations.

Another improvement that would be effected under the mandatory partnership tax system (which would be applied to over 95 percent of regular business corporations) is a reduction in the degree of tax sophistication required to manage a small business without incurring a tax burden

significantly above that which would be produced by optimum tax planning. Many forms of tax management involving the corporate tax method call for a high degree of tax sophistication. This is also true of Subchapters K and S, but the yield from most sophisticated maneuvers under the partnership tax method are, in general, considerably lower than those obtained under the corporate method. The partnership tax method has nothing to compare with the segregation of business income as entity income (nontaxable to individuals until distributed) found under the corporate tax method.

Summary. Mandatory application of the partnership method of taxation to closely held corporations would, in the main, bring about a substantial improvement in equity, tax neutrality in small business form selection, and certainty in tax determinations, as compared with that provided by the present system of taxing closely held corporations. These are the principal reasons for adopting a mandatory partnership tax system.

The lack of serious consideration given to the mandatory approach since the 1939 National Tax Association committee made its recommendations can be attributed principally to (1) the doubtful constitutionality of the mandatory approach, (2) the problem of classifying corporations, (3) other anticipated administrative problems, and (4) tax relief needs of small business--some small

corporations would be more heavily taxed under the mandatory partnership tax system than they are under the corporate tax system. These topics are examined in subsequent chapters.

CHAPTER V

CONSTITUTIONALITY OF THE MANDATORY APPROACH

Since the adoption of the Sixteenth Amendment in 1913, Congress has never attempted to tax the undistributed income of a major segment of regular, domestic business corporations directly to shareholders without the shareholders' consent. Various revenue acts have, however, provided for mandatory partnership tax treatment for corporations used principally for tax avoidance purposes, for certain foreign corporations, and for personal service corporations. In each of these cases, the question of the constitutionality of the mandatory approach has been raised. Congress has been particularly sensitive about this issue since the Supreme Court clearly indicated in Eisner v. Macomber (1920) that taxation of undistributed corporate income to shareholders on a mandatory basis is unconstitutional. Decisions in cases subsequent to the Macomber case indicate the opposite. This chapter is devoted exclusively to the constitutional issue.

One may reasonably ask: what difference does it make whether the mandatory approach is constitutional or unconstitutional? If it is unconstitutional, just amend the constitution. Needless to say, constitutional amendments

are not taken lightly by either the U. S. Congress or state legislatures. Moreover, the political feasibility of adopting the mandatory approach would be greatly impaired if it were declared unconstitutional. With a constitutional amendment requiring a two-thirds approval of both houses of the U. S. Congress to propose the amendment and ratification by three-fourths of state legislatures to make it law,[1] opponents of the mandatory approach could easily defeat the measure. The opponents would consist principally of (1) shareholders who would have their tax burden increased and (2) certain economists and members of Congress who are particularly concerned about tax relief for small business.

Constitutionality of Federal Income Taxation, in General

Revenue Act of 1894. Although federal income taxes were collected during and immediately following the Civil War, the history of modern federal income tax law begins with the Revenue Act of 1894. Under the 1894 act, a tax was levied on both corporate and personal income.[2]

In 1895, the Supreme Court in Pollock v. Farmers' Loan & Trust Co. ruled that the Revenue Act of 1894 was unconstitutional and void. Article I, Section 9, Clause 4 of the

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[1]U. S. Const., Art. V. A constitutional amendment may also be proposed by the legislatures of two-thirds of the states; however, this is not the usual procedure.

[2]28 Stat. 509.

Constitution states: "no Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration hereinbefore directed to be taken." Obviously, an income tax does not satisfy the state apportionment requirement. The Court, therefore, had merely to rule that the income tax was a direct tax. In a 5-4 decision, the Court found:

> The tax . . . so far as it falls on the income of real estate, and of personal property, being a direct tax, within the meaning of the constitution, and therefor unconstitutional and void, because not apportioned according to representation, all these sections constituting one entire scheme of taxation, are necessarily invalid.[3]

The Court's ruling that a tax on income from real estate and personal property is, in substance, a direct tax on the property itself covered such a vast amount of business and personal income that no attempt was made to rewrite the 1894 law to include only salary income and other forms of income, a tax on which might conceivably be construed to be an indirect tax in a future Supreme Court case.

Corporate Excise Tax Act of 1909. To circumvent the Pollock decision, in 1909 Congress levied a "special excise tax" on the net income of corporations for the privilege of doing business as corporations--joint stock companies, associations, and insurance companies were also subject to this tax.[4]

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[3]158 U. S. 601, 3 AFTR 2602 (1895).

[4]36 Stat. 11.

In Flint v. Stone Tracy Co., the Supreme Court upheld the constitutionality of the corporate tax on the grounds that it was not a direct tax but an excise or indirect tax levied upon "the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organizations."[5] With respect to the selection of income as a tax base and to the taxation of income from real estate and personal property, the Court stated:

> It is . . . well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is non-taxable. Applying that doctrine to this case, the measure of taxation being the income of the corporation from all sources, as that is but the measure of a privilege tax within the lawful authority of Congress to impose, it is no valid objection that this measure includes, in part at least, property which as such could not be directly taxed. (220 U. S. 165)

The rationale stated above is essentially the same as that used to remove federal estate and gift taxes from the direct tax category. The latter are construed to be, not direct taxes on property, but "excise" or "indirect" taxes on the "transfer" of property--the property itself merely provides the tax base.[6]

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[5]220 U. S. 107, 3 AFTR 2834 (1911).

[6]New York Trust Co. v. Eisner, 256 U. S. 345 (1921) citing Knowlton v. Moore, 178 U. S. 41 (1900).

Sixteenth Amendment. The desire of Congress to expand its power to tax other forms of income, coupled with the devious aura of the corporate excise tax, led to the adoption of the Sixteenth Amendment. This Amendment was passed by Congress in 1909 and ratified by the required number of states in 1913. The Sixteenth Amendment reads as follows:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

A casual interpretation of the Sixteenth Amendment may lead one to believe that it is essentially a blank check for Congress to impose any reasonable scheme of income taxation without regard to state apportionment. The Supreme Court, however, has not generally interpreted the Sixteenth Amendment this liberally. In particular, in Eisner v. Macomber (discussed below) the Supreme Court sought to limit the power of Congress to tax income by defining income in a rather limited manner.

The Corporate Excise Tax Act of 1909 was superseded by the Revenue Act of 1913, which imposed a tax on both corporate and personal income.[7] All of the revenue acts since 1913 have deleted parts of, revised, or added to previous revenue acts. The entire lineage of present federal income

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[7] 38 Stat. 114.

tax law stems from the Sixteenth Amendment and the Revenue Act of 1913.

Taxation of Undistributed Corporate Income before Macomber

Prior to 1921, taxation of undistributed corporate income to shareholders on a mandatory basis was employed in two general areas: (1) where corporations improperly accumulated income to avoid the surtax at the shareholder level and (2) for personal service corporations.

Accumulated earnings. Under the 1913 act, shareholders of a corporation that was "formed or fraudulently availed of for the purpose of preventing the imposition of" the individual surtax on shareholders were liable for the surtax on their proportionate shares of the corporation's undistributed income.[8] This method could be applied only in cases in which "the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business."[9] This provision remained substantially unchanged

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[8]Revenue Act of 1913, sec. 11(A)(2). Prior to 1918, the individual surtax (which was the progressive element of the tax) was referred to as the additional tax. The accumulated earnings tax provision referred only to avoiding the individual surtax for the following reasons: (1) from 1913 to 1936, the individual normal tax and the corporate income tax were either the same or fairly close to each other and (2) dividends were excluded from the individual normal tax until 1936.

[9]Ibid.

until 1921.

With the Revenue Act of 1921, Congress repealed this provision and adopted a different approach to the accumulated earnings problem. The new approach consisted of an alternative: (1) a 25 percent penalty tax on corporate income improperly accumulated could be imposed at the corporate level or (2) if all the shareholders agreed, the Commissioner could tax the undistributed income of the corporation directly to the shareholders, in lieu of all other income and penalty taxes.[10]

The change from mandatory allocation of undistributed income was explained by the House Ways and Means Report as follows: "By reason of the recent decision of the Supreme Court in the stock dividend case (Eisner v. Macomber, 252 U. S., 189), considerable doubt exists as to the constitutionality of the existing law."[11] (Italics mine.)

With respect to the constitutionality of taxing consent dividends to shareholders, it is well established in tax law that the constitutional issue does not arise where a taxpayer is given a choice between one method of taxation which is considered constitutionally valid and another method which

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[10]Revenue Act of 1921, sec. 220., 42 Stat. 227.

[11]U. S. House, Committee on Ways and Means, Revenue Bill of 1921, H. Rept. 350, 67th Cong., 1st. Sess., 1921, pp. 12-13.

alone is either unconstitutional or of doubtful constitutional validity.

Personal service corporations. Beginning with the Revenue Act of 1918, personal service corporations were taxed like partnerships on a mandatory basis. A personal service corporation was defined as one in which the principal owners were regularly engaged in the active conduct of the business and in which capital was not a material income producing factor.[12] The rationale for this special tax treatment was that the earnings of such corporations were essentially equivalent to the earnings of individuals; therefore, the corporate entity should be ignored for tax purposes.[13]

With the Revenue Act of 1921, Congress also abolished this special form of tax treatment, principally because of the doubtful constitutionality of the mandatory partnership approach arising from the Macomber case.[14] The Treasury Department took the position that Eisner v. Macomber did not affect the constitutionality of personal service corporation

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[12]Revenue Act of 1918, sec. 218, 40 Stat. 1057.

[13]Sydney A. Gutkin, "Section 725: Personal Service Corporations," Tax Law Review, III (October-November, 1947), p. 91.

[14]Revenue Act of 1921, sec. 218(d), 42 Stat. 227.

provisions.[15] Nevertheless, Congress decided to eliminate the provision and specified in section 1332 of the 1921 act that should the partnership tax treatment provided personal service corporations under the 1918 act be declared unconstitutional, these corporations would be taxed for the years 1918-21 on the same basis as other corporations.

The constitutionality of neither the original accumulated earnings provision nor the personal service corporation provision was ever tested directly in a major court case.[16]

Eisner v. Macomber, 252 U. S. 189 (1920)

Background. Under the Revenue Act of 1913, nothing was stated about stock dividends. The Treasury Department, however, attempted to tax stock dividends under the catch-all provision contained in the 1913 act, which stated: net income shall include "dividends," and "gains or profits and income derived from any source whatever."[17] In Towne v. Eisner (1918), the Supreme Court rejected the Treasury's position on the grounds that a stock dividend did not constitute income within the meaning of the 1913 act.[18]

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[15] 3 C. B. 198 (1920).

[16] Rudick, op. cit., p. 174 and Gutkin, op. cit., pp. 90-91.

[17] Revenue Act of 1913, sec. 11(B).

[18] 245 U. S. 418. The stock dividend in question had been distributed in 1914.

The Revenue Act of 1916, on the other hand, explicitly stated that a "stock dividend shall be considered income, to the amount of its cash value."[19] It was under this act, which removed all doubt as to the intent of Congress with respect to whether stock dividends constituted taxable income, that the constitutional issue was tested in the Macomber case.

The basic issue. As stated by the Court:

> This case presents the question whether, by virtue of the 16th amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.[20]

If a stock dividend were considered "income," then Congress could tax this income without regard to state apportionment. If, on the other hand, a stock dividend were considered to be merely a division of the shareholder's capital interest into smaller shares, then a tax on the stock dividend would constitute a direct tax on capital (or personal property, the stock), which must be apportioned according to state population.

In a 5-4 decision, the Court found that issuance of a stock dividend does not produce taxable income.

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[19] Revenue Act of 1916, sec. 2(a)(8)(9). 39 Stat. 756.

[20] 252 U. S. at 200. The stock dividend in question (common on common) had been issued by Standard Oil Company of California to Mrs. Macomber in 1916.

> We are clear that not only does a stock dividend take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction. (252 U. S. at 212)

Significance of the case. For purposes of this study, the decision made in Eisner v. Macomber with respect to whether a stock dividend produces taxable income under the corporate tax method is not important. Under the partnership method of taxing corporations, stock dividends and stock splits merely involve adjustments in the basis per share of the shareholder's interest. Since income is taxed to shareholders when it is realized at the corporate level, taxing stock dividends to shareholders would necessarily involve a double counting of the same income.

The importance of the Macomber case, on the other hand, derives mainly from the fact that the Court did not restrict itself to the narrow question of whether the taxation of stock dividends was consistent with the corporate tax method. Instead, the Court defined income within the meaning of the Sixteenth Amendment (a definition which has had an important bearing on many aspects of federal income taxation) and then proceeded to state why a stock dividend does not fall within that definition. In addition, the Court, in supporting its decision, set forth several important principles pertaining

to the taxation of undistributed corporate income to shareholders.

With respect to defining taxable income, the majority opinion stated:

> In order . . . that . . . the Constitution may have proper force and effect, save only as modified by the Amendment, and the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used; and to apply this distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition [of income] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.
>
> For the present purpose we require only a clear definition of the term "income" . . . .
>
> "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets. (Italics mine.)[21]

In view of the fact that the majority opinion was based on a 5-to-4 vote, it was quite presumptuous of the Court to set forth a general definition of income, which presumably would rule out taxing all forms of unrealized (or non-converted) income. Justice Holmes rejected this narrow definition

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[21] 252 U. S. 207-8. The majority opinion went on to state that income from property is "not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however, invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is income derived

of income and stated in his dissenting opinion:

> I think the word "incomes" in the 16th Amendment should be read "in a sense most obvious to the common understanding at the time of its adoption". . . . The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. (at 220; Justice Day concurred in this opinion).

The majority's opinion that there must be some kind of conversion of or severance from capital before a taxpayer can be said to have received income does not necessarily rule out taxing undistributed corporate income to shareholders. Both partners and shareholders have capital interests in business enterprises; also, in both partnerships and corporations, realization of income initially takes place at the business level. The crux of the question is, therefore: at what point does income realized at the corporate level become realized at the shareholder level? On this point, the majority opinion dogmatically asserted the separateness of the corporate entity: "A stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation prior to dividend declaration."[22]

The most direct statement contained in the majority opinion with respect to partnership tax treatment reads:

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from property. Nothing else answers the description." (at 207)

[22] 252 U. S. 219.

> We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact, but because it is only by recognizing such separateness that any dividend--even one paid in money or property--can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another. (at 214).

The above statement is principally an argument pointing out the inconsistency between (1) taxing corporations and shareholders as separate entities and (2) taxing stock dividends to shareholders, rather than an argument against taxing all corporate income, whether distributed or not, to shareholders. Nevertheless, it is easy to see how this and similar statements cast considerable doubt on the constitutionality of the mandatory partnership approach.[23]

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[23]The majority opinion also stated that Pollock v.

Justice Brandeis, in his dissenting opinion, stated:

> The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporation. No reason appears why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. (at 213; Justice Clark concurred in this opinion)

The majority of Justices appear to have exceeded the subject matter limits of the stock dividend issue by setting forth a general (though extremely narrow) definition of taxable income and by enunciating certain basic principles pertaining to the taxation of undistributed corporate income. Nevertheless, the majority opinion is now part of tax law. It is highly probable that if the constitutionality of the mandatory approach were decided on the basis of the majority

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Farmers Loan & Trust Co., 158 U. S. 601 (1895) overruled the Supreme Court decision in Collector v. Hubbard, 79 U. S. 102 (1871), which upheld the constitutionality of one of the Civil War Income Tax acts which taxed shareholders on their proportionate shares of undistributed corporate income on a mandatory basis.

opinion in the Macomber case alone, it would be considered unconstitutional. However, as explained below, the importance of the Macomber case has diminished somewhat since 1920.

Taxation of Undistributed Corporate Income after Macomber

Mandatory taxation of undistributed corporate income to shareholders of corporations improperly accumulating earnings has never been restored since it was repealed in 1921. The penalty taxes imposed under the accumulated earnings tax provision and under the personal holding company provision (first enacted in 1934) have, in general, been more severe than the taxes that would be paid if shareholders of these corporations were taxed like partners. Both of these provisions, under the current law, permit the deduction of certain consent dividends. However, the consent dividends are still taxed at both the corporate level and the shareholder level--the consent dividends merely by-pass the penalty taxes.[24]

With respect to the constitutional issue, Subchapter S is merely a broad extension of the consent dividend approach. All of the shareholders must consent to the election before it can be used. Consequently, the constitutional issue has not been raised by this provision.

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[24]I.R.C. (1954), sec. 565.

Moreover, in the Congressional reports accompaning the enactment of Subchapter S, nothing was said about constitutionality, nor was any reason given for requiring all the shareholders to consent to the election. The latter probably was made a part of Subchapter S to forestall all questions as to constitutionality and shareholder control over income, with particular regard to minority shareholders.

Since 1920, only shareholders of (1) foreign personal holding companies and (2) certain other controlled foreign corporations have been taxed, on a mandatory basis, on their proportionate shares of certain undistributed corporate income.

Foreign personal holding companies. A special provision for foreign personal holding companies was enacted in 1937 to curtail a flagrant tax avoidance practice. Prior to 1937, U. S. citizens could transfer substantial sums of money to closely held corporations organized in foreign countries with low income taxes and arrange to have these corporations receive all or most of their gross income from foreign sources. Since The United States Government does not have jurisdiction to tax income from foreign sources paid to foreign corporations, the foreign-source income received by these corporations was taxed only when, if ever, it was distributed to U. S. citizens. With entity level taxation of foreign-source income ruled out, the U. S.

Government attacked this problem with a modified, mandatory partnership approach, as explained below.[25]

Under the rules contained in the current law (these are substantially the same as those in the 1937 act), a corportation which satisfies the following requirements is a foreign personal holding company: (1) the corporation is organized under laws of some foreign country; (2) sixty percent or more of the company's gross income consists of foreign personal holding company income, which includes most investment-type income and certain personal service income; and (3) more than fifty percent of the value of the corporation's stock is owned directly or indirectly by not more than five individuals who are citizens or residents of the United States. Foreign personal holding companies are subject to the regular corporate income tax on income from sources within the United States. In addition, each shareholder in the United States must include in his taxable income his proportionate share of "undistributed foreign personal holding company income," which includes certain foreign-source income.[26]

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[25]See: U. S. Congress, Report of the Joint Committee on Tax Evasion and Avoidance, 75th Cong. 1st sess. (1937).

[26]I.R.C. (1954), sec. 551-58.

In Eder v. Commissioner (1943, 2d. Cir.), the Court of Appeals upheld the constitutionality of the partnership tax treatment accorded foreign personal holding companies and stated:

> The purpose of Congress was to deal harshly with "incorporated pocketbooks. . . ."
>
> Interpreting the statute to bring about such a consequence does not render the statute unconstitutional; the Congressional purpose was valid and the method of taxation was a reasonable means to achieve the desired ends.[27]

The foreign personal holding company provision establishes little precedent for mandatory partnership tax treatment for regular domestic business corporations for two reasons: First, it is a well established principle in both general law and tax law that the corporate entity may be disregarded when it is used principally as a means of circumventing statutes or obligations.[28] All of the revenue acts since 1913 have stated, in substance, that use of the corporation as a mere holding or investment company constituted prima facie evidence of the intent to circumvent higher personal income taxes at the shareholder level. Taxing undistributed income to shareholders is merely one

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[27]Eder v. Commissioner, 138 F. 2d 27, 31 AFTR 627 (2d Cir. 1943).

[28]See: George E. Cleary, "The Corporate Entity in Tax Cases," Tax Law Review, I (October-November, 1945), pp. 3-23.

method of disregarding the corporate entity. Thus, there is substantial precedent for according this type of tax treatment to personal holding companies, whether foreign or domestic. On the other hand, there is no common characteristic of closely held (regular, domestic business) corporations that of itself suggests that these corporations are, as a group, using the corporate form to circumvent any tax law. Secondly, the jurisdictional problem associated with taxing foreign corporations obviously has nothing to do with domestic corporations.

Controlled foreign corporations. In 1962, a provision was enacted to tax certain undistributed income of controlled foreign corporations to U. S. shareholders on a mandatory basis. A controlled foreign corporation is one that is more than 50 percent owned by shareholders who own 10 percent or more of the stock of the corporation. Only 10-percent shareholders are taxed on their proportionate shares of undistributed personal holding company income and certain other undistributed corporate income.[29] The rationale for this provision is essentially the same as that for foreign personal holding companies; the latter merely reaches the undistributed income of certain foreign corporations that are not subject to the foreign personal holding company

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[29]I.R.C. (1954), secs. 951-55.

provision.

Since corporations whose gross income consists principally of proceeds from regular business activities may be subject to the tax rules for controlled foreign corporations, this provision provides a better precedent for mandatory partnership tax treatment for domestic corporations than the personal holding company provision. However, the jurisdictional consideration is still present.

This writer has been unable to find a major court case in which the constitutionality of the provision for controlled foreign corporations has been tested. This provision has been in effect since 1963 and there are no immediate prospects for its repeal.

In hearings before the House Ways and Means Committee in 1962, the legal staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department were asked to prepare opinions on the constitutionality of the proposed provision. Relying principally upon (1) the fact that controlled foreign corporations are not necessarily used for tax avoidance purposes and (2) the principles set forth in the Macomber case, the Chief of Staff of the Joint Committee stated in substance that the mandatory approach would be unconstitutional. On the other hand, the General Counsel of the Treasury Department found that it would be constitutional.

In supporting his opinion, the General Counsel relied, in large part, on (1) Eder v. Commissioner (above), (2) the contention of many legal scholars that the principles set forth in the Macomber case have been substantially overruled by subsequent Supreme Court decisions, and (3) Helvering v. National Grocery Co., 304 U. S. 282 (1938).[30]

Court Decisions and Interpretations after Macomber

In contrast to the Macomber case, Helvering v. National Grocery Co. is the most significant Supreme Court case indicating that closely held corporations could be taxed like partnerships, on a mandatory basis, without a constitutional amendment. In this case, Kohl, the sole owner of a chain of grocery stores, contested the constitutionality of the accumulated earnings tax, which had been imposed upon his group of corporations. The Court upheld the constitutionality of the tax over a variety of objections presented on Kohl's behalf.

The majority opinion (there were no dissenting opinions), presented by Justice Brandeis stated, in part:

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[30]U. S. House, Hearings before the Committee on Ways and Means on the President's 1961 Tax Recommendations, 87th Cong., 1st sess., 1961, Vol. 1., pp. 311-22.

> If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. . . . Kohl, the sole owner of the business, could not, by conducting it as a corporation, prevent Congress, if it choose to do so, from laying on him individually the tax on the year's profits." (at 288). (Italics mine.)

With respect to the constitutionality of taxing undistributed corporate income to shareholders on a mandatory basis, one eminent tax attorney has observed: "In view of the statement in the National Grocery Company opinion . . . , the constitutional spectre may be considered embalmed."[31] Many other legal scholars are of the same opinion. Certainly, the statement would seem to be as important as the majority opinion in the Macomber case.

In the National Grocery case, a question was raised as to the validity of taxing minority stockholders on their shares of undistributed corporate income, since such stockholders presumably have little control over dividend policy. The Court refused to rule on this point, stating that in the case at hand there were no minority shareholders. (at 290).

The problem of minority shareholders would seem to be insignificant for several reasons: First, it could be

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[31] Rudick, op. cit., p. 218.

contended that stock is acquired with its burdens.[32] Secondly, on practical grounds, it could be contended that a prospective shareholder would have to be financially ignorant to buy a minority interest in a closely held corporation without some kind of understanding as to corporate income distributions. Moreover, probably over ninety percent of minority shareholders of closely held corporations are relatives of majority shareholders, or close business associates, or wealthy investors who supply a substantial portion of corporate capital--none of whom could reasonably be considered outsiders. Also, if the minority control question is going to be pursued, then the same question must also be asked about junior members of partnerships, who, in many cases, have little effective control over the undistributed income taxed to them.

Since the Macomber case, the Supreme Court has consistently refrained from formulating a new overall definition of income for the purpose of determining whether various items should be considered taxable income within the meaning of the Sixteenth Amendment. Instead, the Court has adopted a case-by-case approach and has sought to limit the effects of its decisions to the particular items in question.[33] The lack of

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[32]United States v. Phellis, 257 U. S. 171 (1921).

[33]Leslie M. Rapp, "Some Recent Developments in the Concept of Taxable Income," Tax Law Review, II (May, 1956), p. 330.

an overall definition of income to replace the Macomber definition is certainly one of the reasons this case has remained a basic source of tax law.

The following are a few of the cases in which the Supreme Court has refused to be restricted by the principles set forth in the Macomber case: (1) Helvering v. Bruun, 309 U. S. 461 (1940)--dealt with the taxation of leasehold improvements to lessor on forfeiture of lease. The court explained that the definition of income used in the Macomber case was adopted to clarify the distinction between an ordinary dividend and a stock dividend and went on to state that is was "not necessary to the recognition of taxable gain that the taxpayer should be able to sever the gain from the capital" (at 469). (2) Commissioner v. Glenshaw Glass Co., 348 U. S. 426 (1955)--pertained to the taxation of amounts received as punitive damages. The Court stated that the Macomber case "was not meant to provide a touchstone to all future gross income questions" (at 431). (3) Helvering v. Griffiths, 318 U. S. 371 (1943)--dealt with stock dividends. Justice Douglas stated in a dissenting opinion:

> The notion that there can be no "income" to the shareholders . . . within the meaning of the 16th amendment unless the gain is "severed from" capital and made available to the recipient for his "separate use, benefit, and disposal" . . . will not stand analysis. (at 381).

Informed legal opinion is divided with respect to the

current importance of the principles set forth in the Macomber case. Some respected tax attorneys have referred to these principles in recent years as though they are as valid today as they were in 1920; e.g., "We believe that the Supreme Court has in no post-Eisner v. Macomber case indicated the slightest relaxation in the rule that realization is necessary before there can be taxable income."[34] Many others hold that, in view of subsequent Supreme Court cases, "Eisner v. Macomber has been whittled down until about all that remains is the rule that a dividend in common stock on common stock is constitutionally exempt."[35] With respect to this remnant, the General Counsel of the Treasury has stated: "There is . . . a very substantial body of opinion that, if faced with the same facts again, the Court would overrule the 1920 decision."[36]

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[34]Edward T. Roehner and Sheila M. Roehner, "Realization Administrative Convenience or Constitutional Requirement?," Tax Law Review, VIII (1952-53), p. 174.

[35]Rudick, op. cit., p. 210. See also: Rapp, op. cit., pp. 329-72.

[36]Hearings on the President's 1961 Tax Recommendations, op. cit., p. 316. See also the General Counsel's opinion on the Constitutionality of the President's 1963 recommendation to tax capital gains from property transferred by donation or death in hearings on the President's 1963 Tax Message, op. cit., pp. 592-98.

Conclusions

Although the issue has never been tested directly in a major court case, it appears that closely held corporations could be taxed like partnerships, on a mandatory basis, without a constitutional amendment. There is, however, little, if any, doubt that passage of a tax law providing for mandatory partnership tax treatment would be followed almost immediately by a major Supreme Court case to determine its consitutionality. Counsel for the taxpayer would base his position principally on the Macomber case. The Treasury Department, on the other hand, probably would base its position principally on the National Grocery case. The decision rendered by the Supreme Court would be more important than those rendered in the Macomber and National Grocery cases combined, with respect to establishing a precedent for treating the corporate entity, for tax purposes, as Congress chooses.

CHAPTER VI

THE MANDATORY SYSTEM: CLASSIFICATION OF CORPORATIONS AND ECONOMIC AND RELATED CONSIDERATIONS

This chapter examines major issues and problems related to: (1) the selection of corporations to be included in the mandatory partnership tax system and (2) economic aspects of taxing closely held corporations like partnerships.

Corporations To Be Included in the Mandatory System

Approaches to the Classification Problem

One of the most difficult problems involved in designing a mandatory partnership tax system is the selection of criteria for purposes of determining which corporations should be taxed like partnerships. Two overlapping, but basically different approaches to this problem seem appropriate: (1) Financial size: Only small corporations could be taxed like partnerships. This would result in large corporations (which comprise the bulk of the big business population) being taxed under the corporate method and small businesses under the individual method. (2) Pattern of ownership and control: Only those corporations whose pattern of ownership and control resembles that of

unincorporated business enterprises could be taxed like partnerships. The latter approach would result in privately held business enterprises, whether incorporated or unincorporated, being taxed under the individual method and publicly held business enterprises (corporations) being taxed under the corporate method.

Financial size. Discussions of corporate income taxation and business income taxation, in general, almost always involve considerations of big business versus small business. Most of the activity in this area revolves around searching for rationales for imposing lighter taxes on small businesses and heavier taxes on large businesses (corporations). Proponents of reduced taxes for small businesses frequently refer to the capital-raising problems, high failure rate, and other disadvantages of small businesses, which presumable are forced to compete with large, established businesses. The same advocates of small business interests are also quick to offer reasons for taxing big businesses (corporations) more heavily. The latter rationales include higher taxes: (1) to discourage economic concentration, with big business viewed as the spawner of all monopolistic business activities; (2) to tax big businesses more heavily for the special advantages they enjoy (access to national capital markets, etc.); and (3) to tax big businesses more heavily in recognition of their greater ability to pay taxes

(business ability to pay is frequently referred to indirectly in Congressional hearings, but never defined). Most of these arguments are grounded more in politics than in economics.

Use of financial size as a basis for discriminating among groups of corporations for purposes of the partnership tax system would appear to be undesirable for three reasons:

1. There is no widely accepted rationale, theory, or justification for taxing businesses according to their financial size. Any acceptable theory of, or approach to, taxing businesses on the basis of financial size would require a delineation of the properties of big and small businesses (however defined) which warrant separate approaches to taxing the two groups. Properties such as control over factor or output markets, access to national capital markets, and other substantive differences between the two groups would be extremely difficult to define and work into a theory of taxation.

2. It would be very difficult to group corporations (in a non-arbitrary manner) according to criteria such as total assets, net income, or gross receipts because the sizes of corporations vary considerably among industries. Establishing size criteria for each industry would be too complicated from an administrative standpoint, especially

since many corporations have highly diversified activities. In addition, the existence of numerous medium-sized corporations, as shown in Table 2 (next page), would make the process of classifying corporations into big businesses and small businesses highly arbitrary.

3. If financial size were used as the main criterion for including corporations in the mandatory system, the pattern of corporate ownership and control would still have to be used as a secondary criterion. For example, if it were decided that all corporations with assets of less than $3 million would be taxed like partnerships, publicly held corporations with assets of less than this amount would have to be excluded from the partnership system for the reasons discussed below. As shown in Table 3, some publicly held corporations have assets that would satisfy any reasonable asset criterion (or other criterion) of a small business.

Pattern of ownership and control. The most reasonable and practicable approach to determining which corporations should be taxed like partnerships is on the basis of ownership and control. Discriminating among groups of corporations on this basis is supported by the following:

1. It is the peculiar pattern of ownership and control in publicly held corporations--i.e., the separation

TABLE 2

NUMBER OF CORPORATIONS BY SIZE OF TOTAL ASSETS IN 1961[a] AND 1963[b]

Size of Total Assets	1961		1963	
Small	No. of Corporations	Percent of total	No. of Corporations	Percent of Total
Under $50,000	506,738	42.6	575,319	43.3
$50,000 under $100,000	206,039	17.3	221,887	16.8
$100,000 under $500,000	350,650	29.5	385,672	29.2
$500,000 under $1,000,000	58,065	4.9	64,950	4.9
Total	1,121,492	94.3	1,245,828	94.2
Medium Sized				
$1,000,000 under $2,500,000	34,967	2.9	39,768	3.0
$2,500,000 under $5,000,000	14,295	1.2	16,003	1.2
$5,000,000 under $10,000,000	8,564	.7	9,289	.7
Total	57,826	4.8	55.060	4.9
Large				
$10,000,000 under $25,000,000	6,105	.5	6,715	.5
$25,000,000 under $100,000,000	3,435	.3	3,925	.3
$100,000,000 and over	1,428	.1	1,659	.1
Total	10,968	.9	12,299	.9
Total, all sizes	1,190,286	100.0	1,323,187	100.0

[a]Source: U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1961-62, Corporation Income Tax Returns, with accounting periods ended July 1961-June 1962 (Washington, D. C.: Government Printing Office, 1965), p. 40.

TABLE 2 (Cont'd.)

[b]Source: U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1963, Corporation Income Tax Returns with accounting periods ended July 1963 - June 1964 (Washington, D. C.: Government Printing Office, 1968), p. 69.

TABLE 3

RANGE OF TOTAL ASSETS AND NUMBER OF SHAREHOLDERS OF CENTRAL TWO-THIRDS OF CORPORATIONS WHOSE STOCK WAS LISTED ON EXCHANGES OR TRADED OVER-THE-COUNTER AT THE END OF 1961[a]

Exchange	Total Assets ($millions)[b] Low	High	Number of Shareholders Low	High
New York Stock Exchange	26.0	440.0	3,310	28,605
American Stock Exchange	3.1	24.6	840	5,200
Major Regional Exchanges	2.0	30.1	333	3,082
Over-the-Counter[c]	.6	36.2	498	3,961

[a]Source: Securities and Exchange Commission, Report of the Special Study of Securities Markets of the Securities and Exchange Commission (Washington, D. C.: Government Printing Office, 1963), Part 2, Table VIII-5, p. 967.

[b]The range presented includes the central 2/3 of corporations in each category; that is, in each category 1/6 of the corporations had less than the low figure and 1/6 had more than the high figure. This procedure excludes extremes, which are somewhat misleading.

[c] Includes only corporations whose stock was actively traded at the end of 1961. Actively-traded was defined as stocks on which 4 or more dealers had entered both "bid" and "offer" quotations in the National Quotation Bureau's monthly Stock Summary of January 1962.

of ownership and control, large number of shareholders, high shareholder turnover rate, and multiple classes of stock--that makes the partnership method of integration unfeasible and undesirable for taxing publicly held corporations. No other substantive aspect of publicly held corporations, including the massive financial size of some of these corporations, precludes taxing all the income of these enterprises directly to their shareholders.

2. Discriminating among corporations in terms of ownership and control is based upon recognition that persons (business owners), not business enterprises, are the focal point for attempting to distribute tax burden in an equitable manner. The nature of the relationship of owners to the business owned -- in particular, whether or not the owners can control the disposition (to themselves) of income realized at the business entity level -- should be the main determinant of which corporations and shareholders should be taxed under the partnership method of integration.

3. There is a basic discontinuity in the distribution of corporations according to ownership and control that facilitates the combining of corporations into non-arbitrary groups. This discontinuity (class in which there are few corporations) consists of the semi-public range of corporations. As explained in the following section, corporations,

as a general rule, attempt to avoid having between 25 and 300 shareholders (the semi-public range). This discontinuity, in general, holds for corporations in all industries. The lack of a similar discontinuity in the financial-size distribution of corporations is one of the principal reasons financial-size would provide a poor approach to grouping corporations for the mandatory partnership system.

To provide perspective for the selection of corporations to be included in the partnership system, it is desirable to begin with an overview of the number and features of corporations according to their pattern of ownership.

Corporations: Publicly held and Privately held

Published statistics on closely held (private) corporations are extremely limited, as compared with those on publicly held corporations. The interests of numerous investors, securities dealers, and the Securities and Exchange Commission assure a continuous flow of statistical data on publicly held corporations. On the other hand, the absence of these factors, coupled with the confidential manner in which the affairs of many closely held corporations are handled, accounts for the dearth of statistics on closely held corporations. Nevertheless, by combining the various data that are available, a fairly good impression of the overall distribution of corporations by number of

shareholders and shareholder control can be obtained.

Publicly held corporations. With respect to defining a publicly held corporation, a recent Securities and Exchange Commission study notes:

> . . at above the 300-shareholder level trading activity, as measured by transfers and dealers interest, becomes significant for a majority of issues affected. It is clear also that under any definition of "public" for purposes of protections of the securities laws, a company with 300 or more shareholders of record is to be deemed public.[1]

The 300-shareholder level provides a convenient cut-off for designating publicly held corporations. In 1963, approximately 7,800 corporations in the United States had 300 or more shareholders. Approximately 2,400 of these corporations had stock that was listed on a national or regional stock exchange; the other 5,400 corporations had stock that was traded over-the-counter.[2]

The total number of publicly held corporations has been growing at a fairly slow rate. From 1950 to 1966, the number of stocks listed on a national or regional stock exchange increased by only 101, as shown in Table 4. The

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[1]Securities and Exchange Commission, Report of Special Study of Securities Markets of the Securities and Exchange Commission (Washington, D. C.: Government Printing Office, 1963), Part 3, p. 34.

[2]Thirtieth Annual Report, Securities and Exchange Commission, 1964 (Washington, D. C.: Government Printing Office, 1965), pp. 46, 55.

TABLE 4

NET NUMBER OF STOCKS ON EXCHANGES FOR SELECTED YEARS[a]

Year, as of June 30	New York Stock Exchange[b]	American Stock Exchange	Regional Stock Exchanges	Total on Stock Exchanges[c]
1950	1,484	779	775	3,038
1955	1,543	815	686	3,044
1960	1,532	931	555	3,018
1961	1,546	977	519	3,042
1962	1,565	1,033	493	3,091
1963	1,579	1,025	476	3,080
1964	1,613	1,023	463	3,099
1965	1,627	1,044	440	3,111
1966	1,656	1,054	429	3,139

[a]Source: Thirty-second Annual Report, Securities and Exchange Commission, 1966, (Washington, D. C.: Government Printing Office, 1967), p. 43.

[b]There is no duplication of listings between the New York Stock Exchange and the American Stock Exchange; stocks listed on one of these exchanges and also on one or more of the regional exchanges are shown as listed only on the New York or American Stock Exchange in this table.

[c]The number of corporations whose stock was listed on one of the exchanges was slightly lower than the number of stocks shown because some corporations had more than one class of stock listed. The 3,091 stocks shown for 1962 were issued by 2,390 corporations; similarly, the 3,139 stocks in 1966 were issued by 2,578 corporations. The number of corporations in each category is equal to roughly 5/6 of the number of stocks shown.

Securities and Exchange Commission has estimated that there were approximately 5,500 corporations in 1961[3] and 5,400 in 1964[4] (with 300 or more shareholders) whose stock was traded over-the-counter. The slow growth in the number of publicly held corporations and the relatively small number of these corporations would facilitate the grouping of these corporations for purposes of the partnership system.

Semi-public corporations. Corporations with between 25 and 300 shareholders are, in the main, semi-public in terms of ownership and control. The distribution of stock among numerous shareholders is similar to that of publicly held corporations. On the other hand, a large percentage of the stock of such corporations is usually held by a few individuals (the founders), which make the control factor similar to that of privately held corporations.

Many, if not most, corporations in the 25-300 shareholder range have attempted, but failed, to successfully issue their stock to the public. As noted in the SEC study above, 300 is usually the minimum number of shareholders required to maintain an active market for a given stock.

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[3] Report of the Special Study of the Securities Markets, op. cit., Part 3, Chapter IX, p. 31.

[4] Thirtieth Annual Report, Securities and Exchange Commission, 1964, op. cit., p.55.

Underwriters handling initial public issues of stock usually attempt to distribute the stock among at least 500 persons.[5] The owner-managers of corporations with 25-300 shareholders are likely to find themselves with all the disadvantages of public ownership (SEC reporting requirements, discontented minority shareholders) and few of the advantages (in particular, an active market for their stock). Similarly, shareholders of corporations in the 25-300 shareholder range are likely to find it difficult to dispose of their stock at a favorable price. For these reasons, the 25-300 shareholder range is usually considered undesirable.

It is difficult to estimate the number of corporations that have between 25 and 300 shareholders. As noted in the Special Study: "It is known that many companies having "public" shareholders (outside investors) are not actively traded or else are not quoted by any dealer. For this category of companies reliable statistics are not available."[6]

The Special Study goes on to state that estimates made by various individuals have placed the number of corporations

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[5]Salomon J. Fink, Equity Financing of Small Manufacturing Companies in New Jersey (Trenton: New Jersey Department of Conservation and Economic Development, 1962), p. 67.

[6]Report of the Special Study of the Securities Markets, op. cit., Part 3, Chapter IX, p. 32.

in the 25-300 shareholder range at two to three times (2-1/2 is used below) the number whose stock is quoted over-the-counter.[7] According to the findings of the Special Study, at the end of 1961, 3,047 over-the-counter companies had between 25 and 300 shareholders;[8] 2-1/2 times this figure yields a revised estimate of 7,618 corporations (less than 1 percent of the corporate population; see Table 2).

Closely held (private) corporations. Twenty-five shareholders represents about the outside limit of stock distribution for privately held corporations. The typical stock ownership pattern in privately held corporations consists of one to three owner-managers (and their wives and children in many cases) owning all the corporation's stock. The vast majority of all closely held corporations appear to be owned in this manner. When the stock of a closely held corporation is distributed outside of the immediate families of owner-managers, it is usually distributed to one or a few of the following: relatives, key employees, and local investors. Local investors who are not close friends or business associates of owner-managers usually demand some share of control over corporate operations to

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[7] Ibid.

[8] Ibid., p. 31.

protect their investments (for example, by being appointed to the board of directors). Outside investors who have little or no effective control over corporate policies are rare among stockholders of privately held corporations. Corporations owned in the manner described above are, in substance, proprietorships or partnerships attired as corporations.

Evidence that substantially all corporations which (1) were not included in the above estimates and (2) were not subsidiaries of those corporations had fewer than 26 shareholders is largely presumptive. There is no way to prove this point one way or another because there is no federal, state, or private agency that attempts to keep track of the number of shareholders of corporations which do not attempt to distribute their stock to the public. There is, however, substantial evidence to support the conclusion that over 95 percent of all corporations (excluding subsidiaries) are family-owned or privately held corporations.

The principal evidence consists of the combination of two sets of data: (1) statistics showing that bulk of the corporate population is composed of small corporations and (2) studies showing how small corporations are financed. In addition, a few statistics on the number of shareholders of small corporations have been compiled.

The studies of small business financing reviewed below used various criteria of "small business" for determining which corporations would be included in the studies. In general, these criteria included corporations with assets of less than $2.5 million (up to $5 million for manufacturing concerns); subsidiaries of large, publicly held corporations were excluded. Since 97 percent of corporations had assets totaling less than $2.5 million in 1963 (94 percent had less than $1 million), the findings of these studies relate to the bulk of the corporate population. (See Table 2 for a complete breakdown of corporations by size of assets).

A study of small business financing was conducted in South Dakota in 1959-60. Firms in all industries were included in this study. Of the 40 corporations included in the sample of firms surveyed, one corporation was not owned by the few persons actively engaged in the management of the corporation.[9] The study explains the limited ownership pattern as follows:

> The sources of equity capital to the firms contacted were limited almost entirely to a proprietor's savings, and in the case of a corporation, the sale of common stock to a few

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[9]Charles N. Kaufman, Financing Small Business in South Dakota (Vermillion: State University of South Dakota, 1960), pp. 15, 59.

> individuals. Almost invariably the funds used to purchase common stock were actually the proprietor's savings also.
>
> Practically all of the corporations were small, closely held ventures. With the exception of one firm, none had considered obtaining funds from the general capital market as most owners felt the worst years were behind them and that the return on their investment would be substantial. These firms also were actually too small to obtain funds from the capital market.[10]

Other studies of small business financing reflect a similar dual pattern which tends to limit the distribution of stock in small corporations to owner-managers and their close associates.[11] First, the vast majority of the owner-managers of small corporations have no desire to obtain outside equity capital, which usually requires: (1) a generous sharing of control and potential gains; (2) an accounting to outsiders for the personal activities (salaries, expense accounts, etc.) of owner-managers, and (3) reduction in the freedom of owner-managers to control corporate income and dividend policy for tax purposes. Secondly, the typical outside investor is not interested in investing in a small corporation that has slow but steady growth potential. As indicated in the following

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[10] Ibid., p. 79.

[11] See also: Deane Carson, The Effect of Tight Money on Small Business Financing, (Providence, Rhode Island: Brown University, 1963), pp. 118-21.

studies, the typical investor in a small corporation wants a fast, large, one-shot capital gain, which comparatively few small corporations can offer:

> The odds are stacked against successful outside investment in small service enterprises. Badly managed, these enterprises can dissipate the capital invested in them. Well managed, the owners may earn respectable livings and good returns on their investments. The earnings, however, are seldom large enough to attract outside funds, even under optimum conditions. . . . The respondents encountered in these interviews tended to be interested in unusual business ventures - "special situations".[12]

> It is ironic that the firms most successful in making offerings to the public in the two years past have been speculative ventures without any operating history. The get-rich-quick segment of the public appears to cherish dreams of huge success in preference to more modest gain in firms with demonstrated fair performance. (Italics mine.)[13]

In addition to the above factors, the cost of obtaining capital from an initial issue of a small amount of stock to the general public is likely to be the most expensive form of financing available to a small corporation, especially when a corporation uses the services of an underwriter. One study of corporations floating new common stock issues of less than $300,000 found that underwriting and related

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[12]G. T. Brown, et al., "Availability and Cost of External Equity Capital for Small Business Ventures," Federal Reserve System, Financing Small Business (Washington, D. C.: Government Printing Office, 1958), p. 526.

[13]Harold W. Stevenson, Equity and Long-term Financing for Small Manufacturing Firms in Minnesota (Minneapolis: University of Minnesota, 1962), p. 47.

floatation costs typically amounted to 18 to 30 percent of the issue price. In addition, the underwriters handling these issues demanded and received generous stock options.[14] On the other hand, some small corporations have been able to privately place their stock with outside investors and avoid high costs of floatation. In any event, the transformation of a family-owned or privately held corporation into a public or semi-public corporation (say one with between 25 and 300 shareholders) is quite a step--one few owner-managers of small corporations are willing or able to take.

With respect to an actual count of the number of shareholders, a survey of small manufacturing firms in Minnesota disclosed the following: average number of shareholders per firm, 5 (2.5 of whom are in management); average largest concentration of stock ownership by a single shareholder per firm, 64 percent (range 30 to 100 percent); shareholders other than the top stockholder, relatives (in 14 corporations), employees (in 5 corporations), and one to a few local investors (in 4 corporations). Completed questionnaires were received from 25 corporations; 79 corporations selected as the sample,

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[14]Fink, op. cit., pp. 82-83.

were mailed questionnaires.[15] Among small corporations in all industries, manufacturing firms tend to be the most widely held because their need for capital is the greatest.

In 1963, there were 139,112 Subchapter S corporations; these corporations were owned by an average of 2.8 shareholders per firm.[16] Since a Subchapter S corporation is permitted to have a maximum of 10 shareholders, the low average of 2.8 provides further evidence that closely held corporations are owned and managed like proprietorships and partnerships. In 1964, there were 922,160 partnerships; these firms were owned by an average of 2.9 partners per firm; 70,830 partnerships had 5 or more partners.[17]

Privately held corporations are, of course, not necessarily small businesses. In a study of 55 multiple corporation cases prepared by the Treasury Department, it was reported that 21 of these corporate groups were wholly owned by either one family or 5 or fewer individuals; four of the corporate groups were wholly owned by 1 individual.

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[15]Stevenson, op. cit., pp. 9, 66.

[16]Statistics of Income, 1963, Corporation Income Tax Returns, op. cit., p. 256.

[17]U. S. Treasury Department, Internal Revenue Service, Statistics of Income, 1964, U. S. Business Tax Returns, with accounting periods ended July 1964 - June 1965, (Washington, D. C.: Government Printing Office, 1967), p. 87.

The combined taxable income of each of the 21 corporate groups was typically in the $100,000 to $500,000 range. One chain of restaurants (51 separate corporations) was wholly owned by one family; the combined taxable income of this chain amounted to $8.1 million in 1963. Another chain of restaurants (26 corporations) was wholly owned by one individual and had taxable income of $.5 million.[18] Obviously, these examples are somewhat extreme, but they serve to indicate the financial-size range of privately held corporations and how closely held these corporations tend to be.

To summarize the preceding statistics, it appears that in 1963 there were approximately 7,800 corporations with 300 or more shareholders, and 7,600 corporations with between 25 and 300 shareholders. The combined number of these publicly held and semi-publicly held corporations (15,400) comprised less than 2 percent of the 1.3 million corporations in 1963. Excluding subsidiaries of these corporations, substantially all of the other 98 percent of the corporate population appears to have consisted of family-owned or privately held corporations, the vast majority of which were owned by fewer than 10 shareholders.

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[18] President's 1963 Tax Message, op. cit., Part 2, pp. 165-179.

There are no indications that there have been any substantial changes in the composition of the corporate population, as between publicly and privately owned, since 1963.

Selection of Corporations

Assuming the mandatory approach is to be adopted, the principal group of corporations to which the partnership tax method should be applied consists of those with fewer than 25 or 30 shareholders; unity of ownership and control is virtually assured in these corporations. As indicated above, an inclusion criterion of 25 or 30 shareholders probably would include over 95 percent of the corporate population. The vast majority of corporations included in the mandatory system would have fewer than 10 shareholders.

The advantages of the corporate tax method would, of course, entice many owner-managers of closely held corporations to seek to avoid having their corporations included in the mandatory system. Consequently, a simple rule such as all corporations with fewer than 26 shareholders will be taxed like partnerships would be inadequate. Those owner-managers who prefer to avoid the system could simply transfer (give, if necessary) one or a few shares of stock to each of 26 or more persons.

To avoid having such simple plays defeat the purpose of the mandatory system, it would be necessary to establish a set of attribution (effective ownership) rules. Rules such as the following would appear appropriate: all corporations with voting stock more than 85 percent of which is owned by not over 20 persons (counting the members of the immediate family as one person) would be included in the mandatory system. Also, in applying the 85-percent test, stock owned by partnerships, trusts, or other corporations controlled by such persons would be considered as owned directly by the persons owning the partnerships, trusts, or corporations in proportion to their interests in these enterprises. The income (whether distributed or not) of corporations falling within the 20-shareholder limit would be allocated directly to the shareholders (whether these shareholders by natural persons, estates, trusts, partnerships, or other corporations) and taxed according to the tax status of the shareholders. Several sets of stock attribution rules similar to this set are presently contained in the Code.[19]

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[19]For an overview of attribution rules, see: Thomas J. Reilly, "An approach to the Simplification and Standardization of the Concepts 'The Family,' 'Related Parties,' 'Control,' and 'Attribution of Ownership,'" Tax Law Review, XV (March, 1960), pp. 253-82.

Attribution rules such as the above would be difficult to avoid without converting a privately held corporation into a semi-public or public corporation. As explained in the preceding section, there are several significant personal and economic factors that would deter the vast majority of owner-managers of private corporations from going public (or semi-public) just to avoid the mandatory partnership system. Private corporations which go public would, of course, be excluded from the partnership system.

A good case could be made for including in the mandatory system many corporations whose pattern of ownership is semi-public (namely those with between 25 and 300 shareholders). Most corporations in this range are closely controlled by a few individuals who own a substantial percentage of the corporation's stock. There are, however, two other considerations which suggest that these corporations should not be included. First, partnership tax rules that are satisfactory (compliance-wise) for corporations with fewer than 25 or 30 shareholders may be quite burdensome for those with 100 or 200 shareholders (this point will become apparent in the next chapter). If, as the statistics in the preceding sections indicate, over 95 percent of corporations have fewer than 25 or 30 shareholders, it would seem imprudent to radically simplify the

rules to be used just to include a few thousand additional corporations. Secondly, if the partnership method were applied to corporations with between 100 and 300 shareholders, numerous minority shareholders who have little control over corporate dividend policy would be taxed on their shares of undistributed corporate income. The latter is one of the principal reasons that the partnership tax method is unsatisfactory for publicly held corporations.

Probably the best way to handle corporations which (1) have fewer than 300 shareholders and (2) are not included in the mandatory system would be to give them the option to be taxed like partnerships, with the consent of two-thirds (or some other suitable percentage) of the shareholders required to exercise the option. Giving an option to these corporations at the margin of the mandatory system would also serve to reduce the pressure involved in setting specific inclusion criteria for the mandatory system.

Corporations with 300 or more shareholders should be taxed under the regular corporate tax system. All the reasons for not applying the partnership method of integration to publicly held corporations with thousands of shareholders apply to those with several hundred shareholders.

Multiple corporations. The use of multiple

corporations is another problem that must be dealt with in determining which corporations should be included in the mandatory system. Controlled groups of corporations fall into two basic groups: (1) parent-subsidiary groups, with the parent corporation owning all or most of the stock of each of two or more subsidiaries and (2) brother-sister groups, with one or a few noncorporate shareholders owning all or most of the stock of each of two or more corporations. Pattern (1) is the approach used by the vast majority of publicly owned corporate groups. Pattern (1) or (2) may be used by privately owned corporate groups. Examples of actual multiple corporate cases are given in the following table:

TABLE 5

EXAMPLES OF ACTUAL MULTIPLE CORPORATIONS CASES[a]

Nature of Business	Pattern of Ownership
Privately Owned Groups	
1. Retail sale of food products.	12 brother sister corporations; each wholly owned by one family.
2. Wholesale sale of beverage and food in one	19 brother-sister corporations; each wholly owned by one family.

TABLE 5 (Cont'd.)

3.	Own and operate apartment buildings.	22 brother-sister corporations. Each apartment it incorporated. Each corporation is wholly owned by one individual.
4.	Fleet of taxicabs in one city.	50 parent-subsidiary corporations. Parent is wholly owned by one individual. Subsidiaries are wholly-owned by the parent.
5.	Retail furniture stores in several cities.	23 brother-sister corporations. Each corporation is wholly owned by two individuals.
6.	Milling; storage and sale of grain, feed and seed; wholesale drugs and other operations.	42 corporations. 37 brother-sister corporations are wholly owned by one family. 5 subsidiaries are wholly owned by several of the brother-sister corporations.
7.	Development and lease of real estate in connection with apartment houses and shopping centers.	69 brother-sister corporations. Each corporation is wholly-owned by one family.
8.	Buying and developing unimproved real estate in connection with the building of a community of houses.	15 brother-sister corporations; each corporation is wholly owned by three individuals.
9.	Clothing concessions in shopping centers.	16 brother-sister corporations; each corporation is wholly owned by two related stockholders.
10.	Finance business.	10 brother-sister corporations; each corporation is wholly owned by three individuals.

TABLE 5 (Cont'd.)

Publicly Owned Groups

11.	Operation of 510 stores in ten states. In addition, operations include feeder-plants to produce many food products.	56 parent-subsidiary corporations. Parent is publicly owned. Subsidiaries are wholly owned by parent.
12.	Beverages, subsidiary companies distribute parent company's product's	14 parent subsidiary corporations. Parent is publicly owned. Subsidiaries are owned by parent.
13.	Beauty salons located throughout the United States.	250 parent-subsidiary corporations. Parent is publicly owned. Subsidiaries are wholly owned by parent.
14.	Finance business.	137 parent-subsidiary corporations. Parent is publicly owned. Subsidiaries are wholly owned by parent.
15.	Retail and wholesale of merchandise, such as appliances and housewares.	74 parent-subsidiary corporations. Parent is publicly owned. Subsidiaries are wholly owned by parent.

[a]Source: U. S. House, President's 1963 Tax Message, Hearings before the Committee on Ways and Means, 88th Cong., 1st Sess., 1963, Part 2, pp. 165-179. The 15 cases shown in Table 5 were selected by the writer from 55 cases reported by the Treasury Department; substantially all of the other cases were similar to those shown above.

The above examples are, of course, extreme examples of multiple corporation cases; most privately owned corporate groups probably use from two to four corporations. These examples were presented by the Treasury Department in support

of the President's recommendation in 1963 to gradually reduce and finally eliminate by 1967 multiple surtax exemptions for controlled groups of corporations. Congress in effect, nullified this proposal in 1964 by giving controlled groups of corporations the option to elect: (1) one surtax exemption for the entire corporate group or (2) one surtax exemption for each corporation in the group and pay a light penalty tax.

If the mandatory system were adopted, the tax savings associated with controlled groups of privately owned corporations could be eliminated. In the case of brother-sister corporate groups, all the income or loss of the corporations could be allocated to the owners as though the business units were a series of partnerships (see Table 5, examples: 1, 2, 3, 5, 7, 8, 9, 10). In the case of parent-subsidiary groups (see example 4), the owners of the parent could be given a choice: (1) to include the income or loss of each subsidiary in computing the income of the parent or (2) go through formal consolidation procedures in computing the income of the combined group (eliminate intercompany items, etc.). In either case, the income of the parent or consolidated group would be taxed directly to its owners. In mixed cases, such as example 6, the income or loss of the subsidiaries of brother-sister corporations could be included in the income of the brother-sister corporations

(perhaps formally consolidated) and the income or loss of the brother-sister corporations could be taxed directly to their owners.

Twenty-five of the multiple corporation cases reported by the Treasury Department consisted of publicly owned corporate groups. Each of the 25 cases involved in the same pattern: the parent was publicly owned and the subsidiaries were wholly owned by the parent. With respect to the mandatory system, these groups do not present the problems of whether and how the income of the corporations in these groups should be taxed to the owners of the groups. Instead, they raise the question of whether or not the groups should be required to file consolidated tax returns on a mandatory basis (consolidation for these groups is optional at the present time). However, whether these corporations file as separate corporations or as consolidated groups, they are still taxed as separate entities. Consequently, determination of how publicly owned groups of corporations should be taxed is peripheral to the overall problem of designing a mandatory system for privately owned corporations.[20]

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[20]For further discussion, see: Richard J. Horwich, "A Comparative Study of Consolidated Returns and Other Approaches to the Multiple Corporations Problem," Tax Law Review, XX (March, 1965), pp. 529-71.

Economic Effects and Related Considerations

Effects on Incentives and Financial Capacity

Among the most important factors that must be considered in determining the desirability of adopting the mandatory partnership tax system are the probable effects on incentives and financial capacity. Changes in the tax burden imposed on the owners of closely held corporations may affect significantly: (1) incentives to form new business enterprises, (2) incentives of owner-managers to work harder (longer hours, expand their volume of business, etc.); (3) incentives of wealthy individuals to invest in existing private corporations. Similarly, changes in tax burden may affect the financial capacity (funds available after taxes) of owners to finance the growth of their corporations. Before considering these factors, it is desirable to review briefly some basic points covered in previous chapters.

As discussed in Chapter IV, adoption of Subchapter S was supported, in large part, as a means of providing tax relief for small corporations. Shareholders of Subchapter S corporations are able to: (1) avoid the double taxation of distributed corporate income; (2) pass through long-term capital gains realized at the corporate level, without

converting these gains into ordinary income; and (3) offset corporate net operating losses against other personal income. None of these advantages are formally available to shareholders of closely held corporations subject to the corporate tax method. However, shareholders of these corporations may still avoid the double taxation of corporate income by siphoning off the income of a corporation through salaries, etc. (see Chapter II). The latter approach produces tax results that are, in many cases, similar to those obtained under Subchapter S.

In 1962, 69 percent of corporations with assets of less than $1 million reported either a net loss or taxable income of less than $5,000.[21] The officer-shareholders of many of these corporations arrange (either under Subchapter S or through the siphoning process) to avoid all or most of the corporate tax year after year. Individuals who find the continuous avoidance of the corporate tax advantageous are principally those in low to low-middle income tax brackets, with marginal rates seldom exceeding 35 percent. These individuals would not be affected significantly by the adoption of the mandatory system. In addition, shareholders in middle to low tax brackets who are poorly informed

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[21] Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., p. 206.

tax-wise (e.g., those who have their corporations distribute a large amount of dividends, which are double taxed) would, in most cases, realize tax reductions if the mandatory system were adopted. It is highly probable that at least half the shareholders of corporations included in the mandatory system would experience either (1) a tax reduction or (2) no appreciable increase in tax burden (say, over 5 percent).

The situation would be considerably different for many shareholders in upper-middle and high individual tax brackets. For these individuals, the corporate tax method provides considerable opportunity for shielding substantial amounts of business income from the heavy impact of the progressive personal income tax. Business income may be taxed at low effective corporate rates and, in many cases, left in the corporation (or group of multiple corporations) indefinitely. Moreover, even though the income retained in the corporation may be taxed (usually as long-term capital gain) again when distributed, the distribution and accompanying tax may be postponed for many years. The net effect is that the current tax outlay on income retained in the corporation may be considerably less than it would be if no corporate tax were paid and the retained income were taxed directly to the shareholders, as proposed under the mandatory partnership

tax system. In many cases, substantial amounts of retained corporate income presently taxed at effective corporate rates in the 22 to 35 percent range would, under the mandatory system, be taxed at individual marginal rates in the 40 to 60 percent range, on a current basis.

Incentive to form new business enterprises. It is unlikely that the adoption of the mandatory partnership tax system would have a significant affect on the incentive to form new business enterprises. As pointed out in the findings of a series of studies conducted at Harvard University, tax considerations do not appear to affect the incentive to form new businesses for two reasons:

> The first is that at the time a new business is organized only the crudest estimates of its profit potentialities can be made. The impossibility of estimating profits prospects with any degree of precision at this stage of a corporation's development tends to preclude a careful evaluation of the effects of taxes on these indefinite profits prospects. . . .
>
> A second reason . . . is that the kind of individuals who are interested in organizing new businesses are often motivated to a marked degree by non-pecuniary considerations. They tend to be aggressive, confident in their ability to succeed, anxious to be their own boss, and desirous of developing a new "idea" in which they are intensely interested.[22]

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[22]J. Keith Butters, "Taxation, Incentives and Financial Capacity," American Economic Review, XLIV (Supplement, May, 1954), p. 515.

The same work also notes with respect to individuals in high tax brackets: ". . . there is no reason to believe that individuals with the desire and talents required to inaugurate a new enterprise successfully are heavily concentrated in the upper income brackets. . . ."[23] In addition, under the existing tax system, the vast majority of new business enterprises are either unincorporated or Subchapter S corporations (see Table 1).

Incentive to work and expand existing enterprises. Although it may be assumed that officer-shareholders in high tax brackets would be inclined to work less under the partnership tax method than under the corporate tax method, neither economic theory nor available studies of the effects of high progressive income taxes will support this assumption. Economic theory merely bogs down in uncertainty as to which effect of a tax increase is likely to be greater: (1) a person will tend to work less because his after tax yield per work unit decreases or (2) a person will work more to maintain his previous level of disposable income. Which tendency has the greater effect is likely to be determined by personal values and various other non-tax considerations.

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[23] Ibid., p. 516.

A significant study of the effects of high progressive income taxes on the incentive to work was conducted in England in 1956. In this study, 306 solicitors (lawyers) and accountants were personally interviewed by the researcher concerning the effects of taxes on their incentives to work longer or shorter hours and expand or contract the volume of business undertaken. At the time of the study, marginal tax rates in England applicable to income of married couples were higher than those in the United States at all income levels and more than twice those of the United States on personal income in the $5,000 to $50,000 range. Sixty-three percent of the persons interviewed faced marginal tax rates greater than 50 percent.[24]

According to the findings of the study, the majority of those interviewed did not work more or less because of the high progressive taxes, approximately 6 percent worked less and 8 percent worked more; no clear pattern of net incentive or disincentive was revealed.[25] The researcher summarized his findings as follows:

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[24]George F. Break, "Income Taxes and Incentives to Work: An Empirical Study," American Economic Review, XLVII (September, 1957), pp. 529-49.

[25]Ibid., pp. 542-43.

> The fact that neither the qualitative nor the quantitative dimension of the problem can be measured with any precision, however, means that . . . any estimate of the magnitude of the net effect, is almost purely speculative. It can be stated with considerable certainty, nonetheless, that this net effect, be it disincentive or incentive, is not large enough to be of great economic or sociological significance.
>
> On the whole . . . there is no escaping the fact that, thus far at least, disincentives, like the weather, are much talked about, but relatively few people do anything about them.[26]

The findings of the above study are particularly relevant to the problem at hand because the persons interviewed were (1) self-employed, as sole proprietors or partners; (2) able to vary their hours and volume of business, without facing the institutional rigidities of salaried employees; and (3) well informed about taxation. Thus, the position of these individuals is similar to that of many officer-shareholders in high income tax brackets who would be taxed like partners under the mandatory system. It should also be noted that most officer-shareholders would face marginal rates considerably lower than those faced by the individuals in the above study.

The findings of other studies are consistent with

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[26] Ibid., pp. 543-49.

those reported above.[27] Thus, there is no reason to expect that the adoption of the mandatory system would adversely affect, to a significant extent, the incentive of officer-shareholders to work or to expand their businesses. The importance of non-tax considerations associated with working are often under-valued by those who predict that given increases in taxes will have dire effects on incentives.

Incentives of wealthy individuals to invest in private corporations. Sale of stock to one or a few wealthy, local investors has been mentioned frequently in financial literature as a possible source of capital for some small, growing enterprises. The incentive of these individuals to invest in closely held corporations has been attributed principally to the possibility of realizing substantial amounts of long-term capital gain on their investments, rather than large amounts of ordinary income.[28] Under the mandatory system, the opportunity to convert substantial amounts of ordinary income into long-term capital gain by

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[27]See: Butters, "Taxation, Incentives and Financial Capacity," op. cit., pp. 508-10.

[28]J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation: Investments by Individuals (Boston: Graduate School of Business Administration, Harvard University, 1953), pp. 34-43.

accumulating income in closely held corporations would be virtually eliminated. Thus, it is reasonable to expect that many of these investors would not be interested in assuming the risk associated with investing in developing enterprises when the possible return on their investments would consist mainly of ordinary income.

Assuming for the present that this kind of incentive would be reduced, it is still doubtful that the growth of many developing enterprises would be adversely affected by a marked reduction in this particular source of capital. Very few small corporations appear to depend on this source of capital. Of the 40 small corporations included in one survey, only one had stock owned by a few local investors.[29] Similarly, of the 25 small manufacturing firms surveyed in another study, only 4 had stock owned by local investors.[30]

As a group, small, growing manufacturing firms typically have the greatest need for long-term debt or equity capital and offer the greatest growth potential. Apparently, wealthy individuals do not represent an important source of capital even for small manufacturing firms:

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[29]Kaufman, op. cit., pp. 15, 59.

[30]Stevenson, op. cit., p. 66.

> The "average" small manufacturers apparently cannot regard the wealthy individual as a potential source of capital, in part because he does not choose to and in part because he is not sufficiently attractive for the capital. The wealthy individual desires an equity position with potential rewards to be achieved through capital gains through annual growth of 15 to 20 percent and a likely public offering in three to five years. Few small manufacturing firms satisfy these conditions.[31]

Effects on financial capacity. The owners of small, closely held corporations rely heavily on internally generated funds and their own personal savings to finance business growth. By reducing the amount of these funds and savings, a tax increase may reduce the growth rate of several thousand small corporations owned by individuals in upper-middle and high income tax brackets. As noted in the findings of the Harvard series of studies:

> To the extent that the tax structure has impaired the performance of the economy, our data point consistently to the conclusion that it has done so much more by restricting the financial capacity of key groups in the economy than by impairing the incentives of these groups. This conclusion holds especially for the effects of taxes on the rate of expansion of business enterprises, particularly of small companies with promising growth prospects.[32] (Italics mine.)

Small, growing corporations owned by individuals in

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[31]Stevenson, op. cit., pp. 32-33.

[32]Butters, "Taxation, Incentives and Financial Capacity," op. cit., p. 505.

upper-middle and high income brackets probably include much of the cream of the small business crop. With the exception of certain professional service organizations, unincorporated business enterprises are usually incorporated for tax purposes when the businesses become highly profitable. Thus, the possibility that the mandatory partnership tax system would tend to reduce the growth of some of the nation's most successful small businesses warrants serious consideration.

It is certainly reasonable to assume that owner-managers of several thousand small corporations (possibly as many as 200,000 corporations) would have their current tax payments increased by twenty percent or more if the mandatory system were adopted. It is also reasonable to assume that this increase in tax payments would significantly reduce the internally generated funds available to finance business expansion. However, it does not follow that the growth of all these corporations would be curtailed significantly. Many of these corporations have little, if any, growth potential that requires a lot of growth financing. In addition, those corporations that are both highly successful and have significant growth potential are the most likely (of all the small business enterprises) to obtain outside long-term debt or equity

capital to finance the growth. Nevertheless, it is reasonable to expect that the reduction in financial capacity would reduce the growth rate of some small corporations.

For those who believe strongly in encouraging the growth of small business enterprises, the inequity resulting from permitting certain individuals to avoid the full impact of the individual income tax may seem to be a small price to pay to help finance the growth of small business.[33] However, there is still another side to this equity-growth dilemma, namely, the encouragement the corporate tax method gives to the hoarding or misallocation of investment funds. In a paper submitted to the Joint Committee on the Economic Report, one economist suggested that mandatory partnership tax treatment for privately held corporations be considered as a means of curtailing corporate hoarding:

> Private corporations now appear to be in a good position to hoard corporate earnings with impunity--instead of directing such earnings currently to real investment or to dividends . . . apart from considerations of tax equity, this has implications relating to the growth of the economy.
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> . . . . . .

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[33]James K. Hall, "Small Business and the Non-integrated Income Tax Structure," paper submitted to the Subcommittee on Tax Policy, Joint Committee on the Economic Report, U. S. Congress, Federal Tax Policy for Economic Growth and Stability, 84th Cong., 1st Sess., 1955, p. 685.

> . . . owners of private corporations who find that the essential or perhaps sole inducement to corporate hoarding is avoidance of personal tax presumably have little or no intention of directing these liquid savings to real investment.
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> . . . . . .
>
> To the extent that there is a greater relative volume of corporate hoarding . . . corporate real investment will be synchronized less closely to profits realization both in amount and time.
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> . . . . . .
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> It is impossible to say what proportion of the retained earnings of private corporations, at any one time, constitutes a measure of hoarded funds. That the aggregate of such funds may not be inconsiderable finds support in the higher bracket rates of personal tax and the wide awareness of this method of tax avoidance.[34]

Under the partnership method of taxation, the decision to (1) leave income in a corporation to finance corporate expansion or (2) distribute the income for consumption or outside investment purposes would be tax neutral. Corporate income would be taxed when earned, whether or not distributed, and previously taxed income would not be taxed again when distributed. There would be an incentive to retain (re-invest) corporate income only when the expected return on the investment is greater than that on outside investments. Under the corporate tax method, on the other

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[34] Ibid., p. 689.

hand, the return on outside investments has to be considerably greater than that on corporate investments to warrant distribution because of the presence of a second tax on distributed income. With respect to the effect on channeling investment funds into the most profitable (efficient) uses, the partnership tax method would appear to be far superior to the corporate tax method.

To conclude this section, it appears that the adoption of the mandatory partnership tax system would not affect, to a significant extent, the incentives of individuals to form, operate, and expand small business enterprises. In addition, a fairly significant improvement in the allocation of resources would likely accompany the adoption of the mandatory system. On the other hand, there would be a significant reduction in the financial capacity of owners of some corporations to finance business growth. Overall, the economic effects of adopting the mandatory system would appear to be mostly repressive or undesirable with respect to encouraging the growth and development of small business enterprises.

Effects on Tax Revenue

Adoption of the mandatory system would most likely produce only a small change in total tax revenue. This follows from the fact that approximately two-thirds of the

corporations that would be included in the system are currently paying little or no corporate income tax;[35] the shareholders of these corporations either file under Subchapter S or they siphon off substantially all the corporation's income. The personal income tax paid by these shareholders would not change appreciably. Most of the other third appear to be realizing tax savings by using the corporate tax method. Consequently, elimination of the corporate income tax paid by these corporations would most likely be replaced by a larger amount of personal income taxes. There would, of course, be numerous offsetting factors--the net operating loss pass-through to the shareholders, elimination of double taxation of dividends, and elimination of capital gain taxes on ultimate realization of retained corporate income--but the overall change would still tend to follow the twofold pattern described above.

Using corporate income tax statistics for 1962 (before the tax rate changes in 1964), it is possible to arrive at a rough estimate of the change in revenue that would have occurred in 1962, had the mandatory system been adopted

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[35] Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., p. 206.

before 1962. Since corporate tax statistics are classified according to balance sheet size, it is necessary to make some assumptions about the asset size categories in which the income, taxes paid, etc., of closely held corporations would be found. Inclusion of 90 percent of the taxable income, etc., of corporations with assets of less than $1 million and 50 percent for corporations with assets between $1-25 million would seem to cover adequately the closely held corporate population, while excluding the income, etc., of publicly held corporations and their subsidiaries. The income of Subchapter S corporations is excluded since they would not affect the change in tax revenue.

Corporations in the size ranges indicated above paid $4.7 billion in corporate taxes (21 percent of the total corporate tax). All of the $4.7 billion would be eliminated. The taxable income of these corporations amounted to $11.9 billion; $2 billion was distributed in cash dividends, leaving undistributed income of $9.9 billion.[36] Using an average rate of 50 percent (for 1962) to represent the net

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[36] Statistics of Income, 1962, Corporation Income Tax Returns, op. cit., p. 58 (90 percent of total income, etc., for corporations with assets less than $1 million; 50 percent for corporations with assets between $1-25 million); also p. 279 for amount of Subchapter S cash dividends to be excluded.

effect of middle and high marginal tax rates, the personal tax on the undistributed income of $9.9 billion would amount to $4.9 billion, which is approximately equal to the loss in corporate income taxes. Elimination of (1) the long-term capital gain tax on undistributed income (assuming it would be paid when the income is distributed or the stock is sold) at an average rate of 15 percent (the maximum rate is 25 percent; some undistributed income would go directly into estates without being taxes); and (2) the 4 percent dividend criedt on distributed corporate income (in effect in 1962) would reduce tax revenue by a net of $1.4 billion. The net of all the changes would be a tax reduction of $1.2 billion (-4.7, + 4.9, -1.4). The net change is equal to less than 2 percent of federal income tax receipts in 1962.[37]

Corporate tax rates in 1962 were: normal rate, 30 percent; surtax, 22 percent. Individual tax rates ranged from 20 to 91 percent. At the present time (1967), the corporate tax rates are: normal, 22 percent; surtax, 26 percent. Individual tax rates range from 14 to 70 percent.[38]

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[37]Total income tax receipts in 1962 amounted to $66.1 billion. The Federal Tax System: Facts and Problems 1964, op. cit., p. 206.

[38]Ibid., pp. 233, 265.

In view of these rate changes, it is highly probable that there would be a small increase in tax revenue if the system were adopted at the present time, rather than a small decrease, as estimated for 1962. The reduction in the corporate normal tax from 30 to 22 percent would likely account for the major difference; most of the income of closely held corporations is taxed only at the normal rate. In any event, the small increase or decrease in tax revenue would not be a major factor in determining the desirability of adopting the mandatory system.

Elimination of the Corporate Surtax Exemption

With the objective to distribute tax burden according to ability to pay, the individual income tax has been levied at progressive rates continuously since 1913. The corporate income tax, on the other hand, has been levied in a graduated form since 1936. Since 1950, the graduation has been in the form of a $25,000 surtax exemption for each corporation. Unlike the individual income tax, the graduation in the corporate income tax has been supported as a special concession to small businesses (corporations), rather than to the owners of small corporations.

Two rather vague rationales have been used to support this special concession. First, it has been contended that small corporations rely heavily on internally generated funds

to finance their growth and development; an effective tax rate much higher than the normal rate would absorb an excessive amount of these funds and thereby hamper the growth of small corporations. Secondly, it has been maintained that the combined corporate tax rate of 48 percent is geared to the taxpaying capacity of large, established corporations. Consequently, small (presumably) growing corporations should not be expected to pay an effective tax (tax paid/net income) that would approach the combined rate.[39] It could also be contended that with individual tax rates ranging from 14 to 70 percent, it would be unfair to expect owner-managers of small corporations to bear a tax on business income (which is in reality their personal income) at a rate (48 percent) approaching the top individual rate, especially when some of the income may be taxed again when it is distributed.

Regardless of the merits of the above arguments, the corporate surtax exemption has spawned numerous problems in business income taxation, including the following: (1) The surtax exemption has for many taxpayers tended to offset the progressivity of the personal income tax system. The flat normal rate of 22 percent provides considerable incentive

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[39] Reexamining the Federal Corporation Income Tax, op. cit., pp. 14-15.

for individuals in middle and high income tax brackets to conduct their private business affairs under the corporate form. (2) The exemption has been the principal stimulus for dividing a business unit into a number of separate corporate forms, when corporate income exceeds $25,000. (3) The surtax exemption has provided substantial and unintended tax reductions for some medium-sized and large business enterprises with operations conducted in multi-outlet form (e.g., see the publicly owned corporations in Table 5).

Under the mandatory partnership tax system, the vast majority of small corporations (that are not subsidiaries of publicly held corporations) would not be subject to the corporate income tax. The question, therefore, arises: if the mandatory system were adopted, should the corporate surtax exemption, which is supported solely as a concession to small corporations, be retained? Retention of the surtax exemption could be supported on the basis that it would provide tax relief for a few thousand small, publicly held corporations. On the other hand, elimination of the exemption would provide two important advantages: (1) It would mitigate substantially the problem of taxing publicly owned groups of multiple corporations. Once the corporate surtax exemption were eliminated, there would be little, if any, incentive to form multiple corporations for tax purposes

(a flat corporate tax rate produces no tax savings when corporate income is divided). In addition, the advantage of being able to offset gains and losses of various corporations in an affiliated group would prompt the vast majority of publicly owned groups to file consolidated tax returns. (2) It would make it much easier to administer the mandatory partnership tax system with respect to keeping closely held corporations in the system. If the surtax exemption were eliminated, the corporate tax method with a flat rate of 48 percent would provide comparatively few shareholders an opportunity to substantially reduce their tax burden by using the corporate tax method (the maximum personal rate is 70 percent). Thus, elimination of the surtax exemption would substantially eliminate the incentive of most shareholders to avoid the classification criteria used in the mandatory system. The design and enforcement of a system of rigorous attribution rules would be much less important if the surtax exemption were eliminated than if it were retained.

On the other hand, elimination of the surtax exemption would only slightly increase the effective tax paid by medium-sized and large, publicly held corporations. For a corporation with taxable income of $200,000 and one surtax exemption, the effective tax rate at the corporate

level is presently 44.8 percent; for a corporation with taxable income of $1 million it is 47.4 percent. An increase to an effective rate of 48 percent would do little to change the tax burden of these and larger corporations. Moreover, if the surtax exemption were eliminated, the flat corporate rate of 48 percent could be reduced at least one or two percentage points, without reducing the tax revenue presently received from these corporations. However, some publicly owned groups of corporations that elect multiple surtax exemptions may have their tax burden increased significantly by the elimination of the surtax exemption; but in this case, the increase must be interpreted as resulting from the elimination of an existing abuse of the surtax concession, rather than from the imposition of a new and significantly higher form of taxation.

Elimination of the corporate surtax exemption, which would be highly feasible if the mandatory system were adopted, warrants serious consideration. If Congress wishes to continue to provide a surtax exemption (or some other form of tax relief) for small corporations not taxed like partnerships, then Congress should specify which corporations (how small, etc.) need the tax relief and confine it to these corporations. Probably no other form of tax relief for small business has been as widely abused by businesses of all sizes as the corporate surtax exemption.

CHAPTER VII

THE MANDATORY SYSTEM: TAX RULES

This chapter examines the major issues and problems involved in designing a system of rules for taxing closely held corporations like partnerships. The material contained in this chapter consists of: (1) a comparison and evaluation of the tax rules contained in Subchapters K and S, (2) an examination of problems peculiar to the mandatory system, and (3) a outline of tax rules appropriate for the mandatory system.

The purposes of comparing the tax rules in Subchapter K and S are first, to point out the numerous factors that owners of privately owned businesses must consider in deciding whether to use the rules of Subchapter K or Subchapter S, under the present tax system, and secondly, to determine the suitability of these tax rules for the mandatory system. Although neither the tax rules contained in Subchapters K nor Subchapter S could be used without modification in the mandatory system, the mandatory system would have to contain many rules that are the same as or similar to those contained in these Subchapters.

Pass-through of Receipts and Deductions

Background. In designing a mandatory partnership tax system for closely held corporations, one important consideration is the extent to which the source characteristics of net income components should be passed through the corporation to shareholders. In terms of extremes, all forms of corporate receipts and deductions may be combined at the entity level and allocated to shareholders as one undifferentiated amount (like a cash dividend). At the other extreme, all forms of income components that are subject to special handling in the computation of individual tax liabilities of shareholders--tax-exempt interest, dividends, capital gains and losses, etc.--may be passed through separately to shareholders and only those items that are not subject to special handling combined into one residual figure. There is a significant trade-off between uniformity in tax treatment and complexity in tax accounting as the pass-through is expanded to include more items.

The complete pass-through (or conduit) approach is best exemplified in the sole proprietorship. The Code does not recognize the proprietorship form of business organization as such; a proprietor is merely an individual who engages in business activities on his own behalf. Thus, for a sole proprietor, there is no form of conversion or

combining of income components at the business level. Items with special source characteristics are reported separately on the proprietor's personal tax return. This procedure has been followed since 1913.

Section II D of the Revenue Act of 1913 specified that a partner must include in his personal income his "share of the profits of a partnership to which . . . [he] would be entitled if the same were divided, whether divided or otherwise. . . ."[1] According to this simplified provision, all components of net income, regardless of source, were combined into one, undifferentiated partnership income figure, which was to be allocated to the partners. Under this procedure, tax-exempt interest on certain state, local, and other bonds received at the partnership level was converted into taxable income at the partner level.[2] One of the first amendments (in 1916) to the original partnership provision specified that tax-exempt interest was to be excluded from the computation of partnership taxable income.[3]

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[1]38 Stat. 169.

[2]Dale E. Anderson and Melvin A. Coffee, "Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K," Tax Law Review XV (March, 1960), p. 288.

[3]Revenue Act of 1916, sec. 8(e), 39 Stat. 762.

Beginning with the Revenue Act of 1917, individuals were permitted deductions for charitable contributions, subject to certain limitations.[4] Section 218(d) of the 1918 act provided that charitable contributions were to be excluded from the computation of partnership taxable income and allocated separately to the partners.[5] This procedure was necessary to present the loss of the deduction (which was not a business expense) and to impose a limitation on the deduction at the partner level, where the tax determination was to be made.

As subsequent revenue acts added other special forms of tax treatment, various provisions were added which specified that these items were to be passed through separately to the partners. By a process of evolution, partnership tax rules gravitated toward the full conduit approach found in the current sections of the Code, under Subchapter K.[6]

The current law. Section 703(a) of the Code provides that "the taxable income of a partnership shall be computed in the same manner as in the case of an individual except

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[4]Revenue Act of 1917, sec. 201, 39 Stat. 1,000.

[5]40 Stat. 1070.

[6]Anderson and Coffee, op. cit., p. 288.

that . . ." (1) items which are subject to special treatment in the computation of the individual tax liabilities of partners must be excluded from the determination of partnership "taxable income" and allocated separately to the partners and (2) net operating losses and personal deductions (personal exemptions, the standard deduction, and itemized deductions) must be deducted, at the partner level.[7]

In addition to a list of items having special source characteristics that must be passed through separately,[8] the Treasure Regulations contain the following catch-all provision:

> Each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.[9]

On his personal tax return, each partner is required to combine items with special source characteristics with similar items he (or his wife, if a joint return) may receive or be allocated from other operations.[10] In addition,

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[7] I.R.C. (1954), sec. 703(a).

[8] I.R.C. (1954), sec. 702(a).

[9] 26 C.F.R. 1.702-1(8)(ii).

[10] Section 702(b) of the Code specifies: "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . shall be determined as if such item were realized directly from the source form which realized by the partnership, or incurred in the same manner as incurred by the partnership."

each partner must report his share of the partnership's "taxable income", the net of items not allocated separately ("taxable income" is somewhat of a misnomer). All the income or loss of a partnership must be allocated to the partners. Allocation is made according to the partnership agreement.

A simplified conduit approach has been used under Subchapter S since its enactment in 1958. Only the excess of net long-term capital gain over short-term capital loss is passed through separately to the shareholders; other receipts and deductions, in general, are combined into one ordinary income figure, which is allocated to the owners in proportion to their shareholdings. A net operating loss incurred at the corporate level is also allocated to shareholders as one undifferentiated amount. As explained in the Senate Finance Committee Report that accompanied Subchapter S, these procedures were adopted in order that "this provision can operate in as simple a manner as possible."[11]

The simplified conduit approach under Subchapter S has been criticized for its lack of uniformity with the

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[11] U. S. Senate, Committee on Finance, Technical Amendments Act of 1958, S. Rept. 1983, 85th Cong., 2nd Sess., p. 88. The original version of Subchapter S proposed by the Senate Finance Committee in 1954 specified that electing corporations would be subject to the rules in Subchapter K, with certain exceptions.

full conduit approach found under Subchapter K. On the other hand, the latter has been criticized for its complexity. An examination of specific differences in the conduit approaches used in these subchapters is contained in the paragraphs below.

Gross Income Components

Tax-exempt interest. Under both Subchapters K and S, interest on state and local bonds and certain other tax-exempt obligations is excluded from taxable income. There is, however, a difference between these subchapters with respect to basis adjustments for tax-exempt interest.[12] Exclusion of tax exempt interest from the tax liability of partners and shareholders would seem to be a minimal requirement for an acceptable conduit approach.

Dividends. If the mandatory system were adopted for closely held corporations, presumably the dividend exclusion would be retained for dividends paid by publicly held corporations. These are the only dividends considered in this section.

Under Subchapter K, dividends are passed through separately. Under Subchapter S, the dividend exclusion is lost; dividends received at the corporate level are combined

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[12]Explained below in this chapter under "Basis adjustments."

with other income and thereby converted into ordinary income at the shareholder level. The pass-through of dividends may exclude a maximum of $100 from the taxable income of each owner.[13]

Retirement income credit. Individuals age 65 or over who meet certain requirements are given a credit against their individual income tax based, in part, on the amount of retirement income they receive. Retirement income includes the taxable portion of income from pensions, annuities, interest, dividends, and certain rents. The maximum annual retirement income credit that may be claimed on a joint return is $457.20 per year.[14]

Under Subchapter K, if any partner is eligible for the retirement income credit, the retirement income received by the partnership must be allocated separately to each partner.[15] Under Subchapter S, on the other hand, retirement income is combined with other income and shareholders over 65 lose any retirement income benefit from this source.[16]

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[13] I.R.C. (1954), sec. 116.

[14] I.R.C.(1954), sec. 37. Individuals under age 65 who receive retirement benefits from a public retirement system may also claim a retirement income credit; however, in this case, retirement income includes only the public-source benefits, which are paid directly to the individuals.

[15] 26 C.F.R. 1.702-1 (8)(ii).

[16] However, dividends paid out of earnings accumulated prior to a Subchapter S election are eligible for the

Recovery of bad debts, prior taxes, etc. Recoveries of bad debts written-off, taxes (but not federal income taxes), and certain other deductions taken in prior years must be included in the gross income of individuals to the extent that the amount recovered reduced taxable income in prior years.[17] Only the portion of the amount recovered that was offset against taxable income in prior years must be included in gross income in the year of recovery.

Under Subchapter K, these recoveries must be excluded from partnership income and allocated separately to the partners in order that each partner may determine the extent to which the amount recovered yielded a "tax benefit" on his personal returns of prior years.[18] Under Subchapter S, these adjustments are made at the corporate level in essentially the same way as a corporation subject to the corporate tax method adjusts for them; i.e., the amount recovered is included in the taxable income of a Subchapter S corporation

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retirement income credit. I.R.C. (1954), sec. 1375 (b).

[17] I.R.C. (1954), sec. 111. The tax benefit rule applies to both business and nonbusiness bad debts, including worthless bonds. The recovery exclusion is not permitted if the reserve method of accounting for bad debts is used. 26 C.F.R. 1.111-1.

[18] 26 C.F.R. 1.702-1(8)(i). In determining whether there was a "tax benefit" on the amount recovered, consideration must be given to net operating loss carrybacks and carryovers and capital loss carryovers resulting from the deduction. I.R.C. (1954), sec. 111.

only to the extent that the amount reduced taxable income of the corporation (whether Subchapter S or regular corporate taxable income) in prior years. No generalization will accurately describe the difference in tax results between the two methods; individual circumstances must be considered.

Deduction Components

The Code imposes limitations on the dollar amount of various deductions, such as charitable contributions. Under Subchapter K, any deductible item on which a limitation is imposed on individuals must be passed through separately to the partners. Each partner must add these items to similar deductions from other sources for purposes of applying the limitations.

Under the corporate tax method, these limitations are imposed at the entity level, where the tax determination is made. With few exceptions, Subchapter S follows corporate rules with respect to these limitations. The items listed below are not passed through to shareholders of Subchapter S corporations; they are deducted, up to the corporate limitation, at the entity level.

Charitable contributions. Individuals who itemize their deductions are permitted a deduction for contributions to approved charitable organizations. In general, the deduction is limited to thirty percent of adjusted gross income. The

limitation on corporations, including Subchapter S corporations, is five percent of corporate taxable income. Since both individuals and corporations are permitted to carryover contributions in excess of these limitations to the succeeding five years,[19] differences in tax results between the two methods would consist mainly of differences in the timing of the deductions.

Soil and water conservation expenditures. Taxpayers engaged in farming operations may elect to deduct, rather than capitalize, certain expenditures for soil and water conservation. The amount of the current deduction, if elected, is limited to twenty-five percent of gross income from farming in the year of the deduction. Expenditures in excess of the limitation may be carried over to succeeding years.[20]

For partnerships, the election is made at the partnership level and both gross income from farming and the related soil and conservation expenditures must be allocated separately to the partners. The twenty-five percent limitation is imposed at the partner level.[21] For Subchapter S corporations, the twenty-five percent limitation is imposed at the corporate level. The difference in the timing of

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[19]I.R.C. (1954), sec. 170 (b) (1), (2).

[20]I.R.C. (1954), sec. 175.

[21]26 C.F.R. 1.702-1(8)(i).

deductions between the two methods is likely to be significant only where some shareholders or partners are engaged in outside farming operations.

Additional first-year depreciation. In addition to regular depreciation, taxpayers (other than trusts) may elect to write off twenty percent of the cost of certain tangible personal property (business equipment mainly) in the first year in which a depreciation deduction is allowable to the taxpayer. The twenty percent, however, applies only to the first $10,000 of investment for corporations, including Subchapter S corporations, and individuals filing separate returns. Individuals filing joint returns may apply the twenty percent to the first $20,000 of investment.[22]

For partnerships, the election is made by the partnership. The maximum amount of investment to which the twenty percent may be applied is equal to the maximum allowable to the partners individually, disregarding all other first-year bonus depreciation claimed by the partners on interests outside of the partnership. The first year additional allowance claimed by the partnership must be allocated separately to the partners for purposes of applying the limitation at the partner level. With respect to the latter, additional first-year depreciation from sources outside the

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[22] I.R.C. (1954), sec. 179.

partnership must be considered.[23]

It follows that the aggregate investment to which a partnership could apply the twenty percent ($20,000 times number of partners is the maximum possible), could be considerably higher than that which could be claimed by one Subchapter S corporation ($10,000). Alternatively, if multiple corporations were used, the aggregate allowable investment could exceed that allowable to partners individually. The Code, however, specifies that certain affiliated groups of corporations will be treated as one for purposes of this limitation.[24] Use of multiple enterprises is an important consideration in setting any kind of entity level limitation, which simplifies tax bookkeeping, as opposed to an individual limitation, which makes the pass-through essential.

Capital Gains and Losses

Under Subchapter K, capital gains and losses realized at the partnership level are combined into three categories and allocated separately to the partners: (1) net short-term gain or loss, (2) net long-term gain or loss and (3) gains and losses on Section 1231 assets.[25] With respect to

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[23]26 C.F.R. 1.179-2(d)(1), (2).

[24]I.R.C. (1954), sec. 179 (d)(6), (7).

[25]I.R.C. (1954), sec. 702(a).

item (3), the Code provides that gains and losses on the disposition of business real estate or any depreciable business property held for more than six months may be combined into one net gain or loss; if the net is a gain, all the gains and losses are treated as long-term capital gains and losses; if the net is a loss, all the gains or losses are treated as ordinary gains and losses.[26] In determining his net 1231 position, each partner must combine all his 1231 gains and losses from the partnership and outside sources.

Under Subchapter S, on the other hand, only the excess of net long-term capital gain over net short-term capital loss is passed through to shareholders.[27] A net short-term capital gain is treated as ordinary income. A net capital loss, whether short or long-term, is not passed through to shareholders, nor is it deducted in computing corporate income. Instead, it is carried forward as a short-term capital loss and offset against capital gains during the succeeding five years. This capital loss procedure is the

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[26]I.R.C. (1954), sec. 1231. Any recaptured depreciation under sections 1245 or 1250 on the disposition of section 1231 assets is, in general, treated as ordinary income under both Subchapters K and S.

[27]I.R.C. (1954), sec. 1375 (a)(1).

same as that used under the regular corporate tax method.[28] The net 1231 gain or loss determination is made at the corporate level--net 1231 gain increases long-term capital gain; net 1231 loss decreases ordinary income.

It is difficult to generalize about the differences in tax results between the two grouping procedures because the differences may be affected by other capital gains and losses the partners or shareholders may incur, as well as by net operating loss adjustments.[29]

Of the two procedures, the Subchapter K pass-through would seem to be preferable. There is no sound reason for not passing through capital losses to shareholders. Moreover, the differences in bookkeeping effort required between the two methods is minor. Certainly, the pass-through of the excess of net long-term capital gain over net short-term capital loss, as found under Subchapter S, is the minimum acceptable pass-through in the capital gains area. Treating long-term capital gain as ordinary income to simplify bookkeeping would involve an unwarranted compromise with

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[28] I.R.C. (1954), sec. 1211(a) and 1212(a).

[29] An explanation of how capital gains and losses are handled in the computation of individual tax liability can be found in any standard tax reference manual.

uniformity and equity in taxation.

Other Items Related to the Pass-Through Problem

Personal expenditures. Under Subchapter K, expenditures of a personal nature made at the partnership level for the benefit of partners must be excluded from the computation of partnership income and allocated separately to the partner. Expenditures of this type include medical expenses, alimony payments, expenses for care of dependents, and similar items.[30] The net effect of this pass-through is the same as if the expenditures had been incurred directly by the partners.

In this area, Subchapter S is considerably less flexible than Subchapter K. Under Subchapter S, there are no procedures for passing through personal expenditures to shareholders. Personal expenditures must be considered either (1) compensation, deducted at the corporate level, and included in the gross income of the recipient shareholders and perhaps treated as an itemized deduction (e.g., alimony payments) or (2) handled as a receivable at the corporate level. The flexibility provided by Subchapter K is certainly desirable in this area.

Investment tax credit. For both partnerships and

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[30] 26 C.F.R. 1.702-1(8)(i).

Subchapter S corporations, the cost of new and used business property which qualifies for the investment tax credit is allocated to the partners and shareholders, respectively. For both types of enterprises, a $50,000 limitation on the cost of used property is applied at the entity level, as well as at the owner level. In addition, all other limitations on the amount of investment tax credit that may be taken in any one year are applied at the owner level.[31]

The investment tax credit differs from the preceding items in that the credit is not related to the computation of entity income. As a direct offset to the tax itself, there is no practical way to adjust entity income for the credit to eliminate the need to allocate the cost of qualified property to the owners. Accounting for the credit could, however, be simplified somewhat by imposing the limitations at the entity level and allocating some flat

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[31]26 C.F.R. 1.48-1, 3, 5. The investment tax credit is equal to 7 percent of the cost of the taxpayer's qualified investment (business equipment mainly). The percentage of the cost of the equipment on which a credit may be taken is dependent upon the useful life of the equipment. The investment credit taken in any taxable year may not exceed the tax liability; other limitations also apply if the credit exceeds $25,000 or if separate tax returns are filed. Any unused credit may be carried back three years and forward five. Also, early dispositions of the property or ownership interests may result in a recapture of all or part of the credits. 26 C.F.R. 146-1, 2; 1.47.

amount of investment tax credit to the owners. This would eliminate the need for allocating the cost of particular kinds of property--brokendown between new and used and by useful life--to the owners.

Miscellaneous. Receipts and deductions similar to those above that must also be allocated separately under Subchapter K, but not under Subchapter S, include: exploration expenditures for mining operations (sec. 615); intangible drilling and development costs (sec. 615); partially tax-exempt interest (secs. 35 and 242); and taxes paid to foreign countries (sec. 904).

Allowed Deductions

In addition to differences in the limitations placed on the amount of various deductions, some items may be deducted by Subchapter S corporations, but not by partnerships. These items are discussed below.

Organizational costs. Corporations, including Subchapter S corporations, may elect to deduct ratably over sixty months or more expenditures incident to the formation of a corporation.[32] These expenditures include items such as legal and accounting fees, printing costs, and

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[32] I.R.C. (1954), sec. 248.

incorporation fees. No similar election is available to partnerships which must capitalize (and deduct when the business terminates) the costs of forming a partnership.

Owners as employees. Salaries and interest paid to partners for services or the use of capital which are not contingent upon partnership income (denoted "guaranteed payments"), may be deducted at the partnership level.[33] These payments are included in each partner's taxable income along with and at the same time as other partnership income allocations. The deduction of guaranteed payments is essentially a profit-sharing arrangement among the partners. With the exception of the allowed deduction of salaries (as guaranteed payments), partners are not considered employees of the partnership for any other purpose.[34] On the other hand, officer-shareholders of a corporation, including a Subchapter S corporation, are, in general, treated the same as other employees. Corporations are permitted a deduction for reasonable compensation paid to employees. This deduction may include several kinds of expenditures for employee fringe benefits, as well as regular salary payments.[35]

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[33] I.R.C. (1954), sec. 707(c).

[34] 26 C.F.R. 1.707-1.

[35] I.R.C. (1954), sec. 162(a).

It is in the fringe-benefit area that officer-shareholders of closely held corporations have a significant advantage over partners. As employees, officer-shareholders are entitled to participate in the following fringe-benefit arrangements which are not available to partners and sole proprietors: group-term life insurance (I.R.C., sec. 79); accident and health compensation (secs. 104-106); employee death benefits (sec. 101,b); meals and lodging for the convenience of the employer (sec. 119); employee moving expenses (sec. 217); stock options (secs. 421-24); and qualified pension and profit-sharing plans (sec. 401,a). With respect to pension plans, partners whose interest in partnership capital or profits exceed 10 percent and sole proprietors may participate in a retirement plan for self-employed individuals (sec. 401,c); however, the plan is, in general, less advantageous than the plan (sec. 401,a) available to officer-shareholders.

Classification of officer-shareholders as employees for purposes of the plans listed above permits a significant amount of indirect (or non-monetary) compensation to be deducted at the corporate level and either (1) not taxed to the officer-shareholders, as in the case of certain insurance premiums, or (2) taxed to the officers at some later date (usually at low effective rates), as in the case of pensions.

A considerable amount of controversy has stemmed from the differences in fringe-benefit plans available to officer-shareholders of corporations (especially Subchapter S corporations) and owners of unincorporated business enterprises. The retirement plan for self-employed individuals enacted in 1962 has done little to placate partners and sole proprietors.[36] As of 1966, thirty-five states had enacted special statutes permitting the formation of professional associations or corporations.[37] The principal purpose of these statutes is to make it possible for doctors, lawyers, and other professional personnel--who may be prohibited from forming a regular corporation because of local laws or ethical codes--to obtain corporate tax status and thereby avail themselves of employee benefit plans.[38] The tax status of professional corporations, as

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[36]Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87-792, popularly known as the "Keogh Act."

[37]Bittker and Eustice, op. cit., p. 38.

[38]Although many professional personnel are in high individual tax brackets, which would suggest the desirability of accumulating income in the corporation to avoid higher personal income taxes, the personal holding company penalty tax probably would curtail this maneuver in many cases. Personal holding company income is defined to include certain personal service income (I.R.C., 1954, sec. 543, a, 7). Consequently, those professional personnel who use the corporate tax form and find their operations subject to the personal holding company tax would presumably siphon off all the taxable income of the corporation through salaries, etc., (see Chapter II), which would leave the employee fringe benefits as the

to whether they are corporations or partnerships, is a subject of continuing controversy.[39]

More uniformity in the fringe-benefit area would appear desirable, whether or not the existing system of taxing closely held corporations is changed.

Other Major Areas

Elections. The Code gives taxpayers numerous elections with respect to the tax treatment of certain items--including cash or accrual basis of accounting, depreciation methods, inventory methods, current write-off or capitalization of several different kinds of expenses, and several other elections. Under both Subchapters K and S, substantially all of these elections are made at the entity level.

Regardless what other rules may be adopted for the mandatory system, the requirement that elections pertaining to accounting for entity income be made at the corporate level is absolutely essential. The administrative and compliance problems that would proceed from having some

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principal tax advantage.

[39]Marcus D. Grayck, "Professional Associations and the Kintner Regulations; Some Answers, More Questions, and Further Comments," Tax Law Review, XVII (May, 1962), pp. 469-89; and Stephen B. Scallen, "Federal Income Taxation of Professional Associations and Corporations," Minnesota Law Review, IL (March, 1965), pp. 603-717.

stockholders use the accrual basis of accounting for their interests in various components of corporate income, while other stockholders use the cash basis for their interests, and from similar split elections would be formidable.

Taxable years. A Subchapter S corporation is free to adopt a taxable year (calendar or fiscal) without regard to the taxable years of its shareholders--this is a regular corporate tax rule. A partnership, on the other hand, may not adopt or change to a taxable year different from that of its principal partners, unless a business purpose for selecting or changing to another year can be established to the satisfaction of the Internal Revenue Service. A new partnership may, however, adopt a calendar year without the consent of the Internal Revenue Service, if the principal partners (those who have a 5-percent or more interest in capital or profits) have different tax years.[40] The significance of the difference in taxable years is limited principally to the deferral of income earned during the first year of business operations.

Shareholders of Subchapter S corporations must include in their personal income cash dividends in the year of receipt. In addition, each shareholder must include in

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[40] I.R.C. (1954), sec. 706(b), 26 C.F.R. 1.706-1(b)(1)(ii).

his personal income his pro rata share of the corporation's undistributed taxable income on the last day of the corporation's taxable year, ending with or within the taxable year of the shareholder. Cash dividends distributed within 2-1/2 months following the close of the corporation's taxable year are considered to be distributions (tax free) of undistributed taxable income of the prior year (to the extent of that income).[41] These procedures must be followed whether the corporation and its shareholders have adopted the cash or accrual basis of accounting. In general, salaries paid to officer-shareholders are included in the officer's personal income in the year received.

A partner, on the other hand, must include his entire share of partnership income allocations in his personal income at the end of the partnership's taxable year ending with or within the partner's taxable year. This procedure must be followed whether the cash or accrual method is used by the partnership and the partners and regardless when withdrawals and "guaranteed payments" (salaries and interest) are made.[42]

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[41] 26 C.F.R. 1.1373-1.

[42] I.R.C. (1954), sec. 706(a).

Of the two procedures described above, the partnership approach is preferable because it prevents the shifting of income between years. For example, under the Subchapter S approach, when the business and its shareholders have different taxable years, income may be shifted between the taxable years of the owners by changing the timing and amount of cash dividends and salary payments. With the partnership approach, business income is included in the owner's income on a consistent annual basis, regardless when the income is distributed.

Ownership transfers. Only Subchapter S shareholders who hold their stock at the end of the corporation's taxable year are taxed on their shares of the corporation's undistributed taxable income. Thus, a shareholder who transfers his stock on the last day of the corporation's taxable year is taxed only on cash dividends received during that year. On the other hand, if the corporation incurs a loss and a shareholder transfers his stock during the year, the loss must be allocated on a daily basis between the old and new shareholder.[43]

It would seem that the small gain in compliance simplicity resulting from not allocating undistributed taxable income according to the period the stock is held

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[43] I.R.C. (1954), sec. 1373, 1374.

is far outweighed by the inequity associated with shifting income from old to new shareholders and from the inconsistency with the loss allocation. The partnership procedure, which requires that a partner report his share of partnership income or loss up to the time his entire interest is disposed of, is a more logical and consistent approach.[44]

Division of income. Partners have more flexibility in allocating business income or loss than Subchapter S shareholders. Under Subchapter S, only one class of stock is permitted and income allocations are made on the basis of the number of shares held. Under Subchapter K, on the other hand, income allocations are made according to the partnership agreement.[45]

In addition to the usual type of partnership income allocation arrangement (e.g., partner A shall receive a salary of $5,000 plus 1/3 of partnership net income or loss), a partnership agreement may provide for special allocations of particular kinds of revenue or deductions and gains or losses to particular partners. For example, one partner may be allocated all the dividend income

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[44] I.R.C. (1954), sec. 706(c).

[45] I.R.C. (1954), sec. 704(a)(b).

received by the partnership or another partner may be allocated all the depreciation on a particular machine. Provided the principal purpose of the allocation arrangement is not tax avoidance or evasion, the arrangement will be accepted by the Internal Revenue Service.[46]

This is one area in which the substantive differences between the corporate and partnership legal forms would seem to call for a lack of uniformity. The basic income allocation agreement for shareholders is that specified by the nature of the stock held. It may be difficult to arrange for special income allocations for tax purposes for closely held corporations for the following reasons: (1) all the shareholders would have to consent to the special allocations and (2) the transfer of stock, unlike the transfer of partnership interests, does not require that a new ownership agreement be prepared. Shareholders of corporations have some flexibility in this area in that they can adjust expense payments to shareholders--salaries to officer-shareholders, etc.--to take into account special income allocations not provided by stock ownership.

Family income splitting. A problem common to both partnerships and Subchapter S corporations is the splitting

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[46]26 C.F.R. 1.704-1.

of income among the members of a family to shift income into lower marginal tax brackets. Since (1) married couples usually file joint returns and (2) comparatively few individuals have income sufficient to warrant spreading it to persons outside the immediate family, this problem is usually encountered where business owners try to shift income to their children.

Although the provisions pertaining to family income splitting differ somewhat between Subchapters K and S, both are based upon the following principles: (1) An individual has a right to make a valid transfer (by gift, devise, or sale) of all or part of his interest in a corporation, or partnership to a member of his family, as well as to outsiders. (2) An assignment of income without a corresponding valid transfer of the property producing that income does not shift the tax on the income to the recipient. (3) In a service-type business, income is taxed to those who perform the services. (4) In a business in which both capital (inventory, machinery, etc.) and services are income producing factors, a reasonable allowance for services performed must be made to the owners performing the services before the remainder of the income may be attributed to and allocated on the basis of the capital supplied by the owners. Income allocations not in accord with these principles may

be re-allocated by the Internal Revenue Service.[47]

The family income splitting problem associated with jointly-owned business enterprises stems from a more fundamental problem: at the individual level, should the tax-paying unit be each person, the married couple, or the immediate family (parents and children at home)? Discussion of this problem is beyond the scope of this study.[48]

Basis adjustments. Determination of the tax basis of a partner's or a Subchapter S shareholder's interest in the business is required for several purposes. For example, the tax basis must be known to determine the extent to which net operating losses may be deducted or for the computation of gain or loss on the sale of the interest.

In general, when a new business is formed, whether a partnership or a corporation, no gain or loss is recognized to the owners or the business on the transfer of assets to the business. The basis of the assets to business is the same as it was in the hands of the owners, and the basis of the owner's interest is, in general, the same as

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[47]I.R.C. (1954), sec. 704(e), 1375(c).

[48]For further discussion, see: Harold M. Groves, Federal Tax Treatment of the Family, Studies of Government Finance (Washington, D. C.: Brookings Institution, 1963), Chapter IV.

the basis of the assets transferred.[49] Subsequent transactions may require numerous changes in the basis of the owner's interest.

Subchapter S contains a simplified procedure for changing the tax basis of a shareholder's stock. The tax basis of the stock is increased by the amount of undistributed corporate taxable income included in the shareholder's personal income and reduced by (1) cash dividends paid out of income taxed to shareholders but not distributed in prior Subchapter S years and (2) net operating loss allocations to shareholders.[50]

Under Subchapter K, on the other hand, a more flexible and complex adjustment procedure is used. The tax basis of a partner's interest is increased by the amount of his share of partnership ordinary income, special income allocations (whether taxable or nontaxable) and excess of percentage depletion over the basis of the depletable property, and reduced by his share of partnership ordinary loss, all special allocations of deductions (whether deductible or nondeductible on his personal return) and withdrawals from

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[49] I.R.C. (1954), secs. 351, 362, 721-23.

[50] I.R.C. (1954), sec. 1376.

the partnership.[51]

The handling of tax-exempt interest provides a good example of the differences in tax results that may be produced by the two procedures. Under Subchapter K, tax exempt interest is allocated separately to the partners and each partner increases the tax basis of his partnership interest for the amount allocated to him. Since the partner's basis is increased for the interest, any gain on the sale of the partner's interest that is attributable to the tax-exempt interest retained in the partnership is not taxed to the partner.[52]

Under Subchapter S, on the other hand, tax-exempt interest is excluded from the computation of taxable income of the corporation; this prevents the interest from being taxed currently to shareholders. However, since the income does not become a part of the undistributed taxable income of the corporation--which would increase the tax basis of the shareholder's stock--a gain on the sale of the stock that is attributable to tax-exempt interest retained in the corporation may be indirectly converted into taxable income

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[51]26 C.F.R. 1.705-1(a).

[52]Victor H. Tidwell, "The Internal Revenue Code of 1954 --Subchapter K and Subchapter S Compared" (unpublished D.B.A. dissertation, Indiana University, Bloomington, Indiana), pp. 53, 179-80.

to the shareholder.[53]

Another difference between Subchapters K and S is the limitation on loss deductions. A net operating loss first reduces the basis of a Subchapter S shareholder's stock and then any corporate debt he may hold, but neither may be reduced below zero. Net operating loss in excess of the combined (stock and debt) basis is forfeited forever.[54]

A loss incurred by a partnership (whether a capital loss or an ordinary loss) also reduces the basis of a partner's interest, but not below zero. However, loss in excess of a partner's basis may be carried over and deducted in future years, when the partner's basis is restored by profits or additional investments. Also, a partner's tax basis includes his share of all partnership liabilities, including amounts advanced by creditors who are not partners.[55]

The partnership limitation is obviously the more generous of the two. The carryover of losses in excess

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[53] Ibid.

[54] I.R.C. (1954), sec. 1376(b).

[55] I.R.C. (1954), sec. 704(d), 26 C.F.R. 1.752-1.

of an owner's basis would seem to be a reasonable provision. Whether an owner's interest should include his interest in business liabilities for amounts the owner has not advanced is questionable. Of course, a partner may be held liable for partnership liabilities in the event of continuing losses, which could result in his loss exceeding his capital and debt interests. On the other hand, a shareholder (at least technically) could lose only his investment (ownership interest and debt) in the event of a business failure. Whether losses in excess of an owner's investment should be indirectly accrued for partners, but not for shareholders, is especially questionable in those cases in which shareholders have personally guaranteed the repayment of loans from outside creditors.

In general, the basis adjustments prescribed by Subchapter K are considerably more refined and complex than those in Subchapter S. The basis area is one of many areas in which Subchapter K substantially compromises simplicity in tax accounting to avoid relatively minor inequities that would result from a more simplified tax accounting approach.

Ownership redemptions, liquidations, reorganizations, etc. Subchapter S corporations are, in the main, subject to regular corporate tax rules in these areas. Subchapter K, on the other hand, contains a substantially different

set of procedures.

The most important factor that calls for different procedures in reorganizations, liquidations, etc., is retained corporate income, which has been taxed at corporate rates, but which has not been taxed to individuals. Corporate tax rules for liquidations, etc., contain numerous safeguards against income distributions which would convert retained corporate income into long-term gain or avoid taxation of this income as ordinary income to shareholders in some other manner.

The retained income problem is, of course, not present in partnerships. A Subchapter S corproation, on the other hand, may have accumulated corporate income under the corporate tax method prior to the Subchapter S election. The presence of accumulated income--some of which has been taxed under the corporate method and some under Subchapter S--can produce some extremely complex problems in the reorganization and liquidation areas, as well as in other areas.

To avoid the dual-source accumulated income problem, the original version of Subchapter S proposed in 1954 specified that the election must be made for the first taxable year of a corporation organized after 1953 or it could never be made and that corporations organized prior

to 1954 would have to liquidate and reincorporate if they wished to exercise the partnership option.[56]

If a mandatory partnership tax system were adopted, the best procedure probably would be to treat the retained corporate income of closely held corporations as though it had all been taxed directly to shareholders (with appropriate adjustments to the basis of the shareholder's stock). This income has already been taxed at corporate rates. Moreover, the temporary inequities associated with the tax-free distribution of this income would far outweigh the tax accounting complexities associated with maintaining a dual-source income distribution system. A one-shot adjustment of this type is not practical under Subchapter S, since the option may be exercised and later revoked easily.

Once the accumulated earnings problem was eliminated, closely held corporations could follow the tax rules under Subchapter K with respect to liquidations, reorganizations, etc.

Restrictions on the use of Subchapter S. Subchapter K permits any party (person, trust, another corporation, estate, etc.) to be a partner. Also, there are no restrictions as to the nature of gross income received.

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[56] Internal Revenue Code of 1954, S. Rept. 1622, op. cit., p. 453.

Subchapter S, on the other hand, permits electing corporations to have only individuals and estates as shareholders. Also, an electing corporation is not permitted to derive more than 80 percent of its gross income from sources outside the United States or more than twenty percent from investment-type income.[57]

The purpose of these restrictions on Subchapter S is twofold: (1) to limit the use of the option to "small business corporations" owned directly or indirectly by not more than 10 individuals, all or most of whom are actively engaged in the conduct of the corporation's business and (2) to restrict the use of the option to corporations engaged in regular business operations, rather than mere investment or holding activities.[58]

Under the mandatory system, it would be necessary to permit any party to be a shareholder and any kind of gross receipts, as is done under Subchapter K. If a corporation were excluded from the mandatory system simply because some of its stock was held by another corporation or a trust, then the mandatory system would be a de facto optional

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[57] I.R.C. (1954), sec. 761(a), 1372(e).

[58] Technical Amendments Act of 1958, S. Rept. 1983, op. cit., pp. 87-89.

system. Officer-shareholders wishing to have their corporations excluded from the mandatory system could simply arrange for stock to be transferred to a non-qualifying party, as can be done under Subchapter S. The same would be true of restrictions on gross income. Moreover, if any kind of priority were established to determine which corporations should be included in the mandatory system, investment-type enterprises (personal holding companies) would rank number one.

Also, a Subchapter S corporation is permitted to have only one class of stock outstanding. The main purpose of this restriction is to simplify the allocation of income among shareholders. As explained in the original proposal for Subchapter S in 1954:

> The corporation may have only one class of stock outstanding. No class of stock may be preferred over another as to either dividends, distributions, or voting rights. If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders.[59]

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[59] Internal Revenue Code of 1954, S. Rept. 1622, op. cit., p. 453.

Under the mandatory system, it would be necessary to include in the system closely held corporations with more than one class of stock; exclusion of those with more than one class would transform the mandatory system into a de facto optional system, as explained above.

Applying the partnership method of taxation to closely held corporations with more than one class of stock would certainly be more difficult than applying it to those with only one class. However, the increase in compliance problems would not make the mandatory system unfeasible. The present Treasury Regulations for foreign personal holding companies specify how this problem could be handled:

> The amount which each United States shareholder must return is that amount which he would have received as a dividend if the . . . portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company, . . . Such amount is determined . . . by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.[60]

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[60] 26 C.F.R. 1.551-2(c).

In closely held corporations, restrictions on voting rights and limitations on financial returns should be viewed as a form of partnership agreement and handled accordingly. Usually only individuals who own regular common stock in a closely held corporation are willing to hold preferred stock.[61]

Conclusions

In selecting a general set of tax rules for the mandatory system, it appears that those contained in Subchapter K would be the most suitable. This writer does, however, have some reservations in recommending the use of Subchapter K rules as the backbone of the mandatory system. In particular, simplicity in tax accounting has been compromised substantially in making the tax rules in Subchapter K uniform with those for proprietors and individuals, in general. In choosing between (1) the complexity of Subchapter K and (2) the lack of uniformity associated with using a simplified partnership design in the mandatory system, it appears that the bookkeeping complexity is the lesser of the two

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[61]For an analysis of ownership agreements and related problems in closely held corporations, see: F. Hodge O'Neal and Jordan Derwin, Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises (Durham, N.C.: Duke University Press, 1961).

evils. Differences between the tax rules in Subchapters K and S have been criticized frequently in tax literature because most of them are unnecessary. On the other hand, the complexities associated with Subchapter K have, to a large extent, been accepted because they are unavoidable in applying the individual tax method to partnerships in a consistent manner (i.e., most of the complexity is unavoidable as long as numerous forms of receipts and deductions are subject to special tax treatment).[62]

Assuming that the tax rules in Subchapter K were to be used as the principal components of the mandatory system, the addition of special rules for items such as the following would be necessary: (1) criteria for corporations to be included in the mandatory system--discussed in Chapter VI; (2) transitional problems--e.g., adjustments for existing retained earnings; and (3) allocations of income among various classes of stock.

Semi-public Corporations

In addition to the mandatory system, in Chapter VI it was suggested that perhaps the best way to handle

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[62]See: U. S. Congress, Hearings Before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J, and K, 86th Cong., 1st Sess., 1959, the section on Subchapter K.

corporations whose pattern of ownership is semi-public in nature would be to give these corporations the option to be taxed like partnerships. If these corporations were given this option, it would be necessary to formulate some additional rules for these corporations.

Two general approaches to the formulation of these special rules seem appropriate: (1) modify and use the rules presently contained in Subchapter S for the tax-option corporations or (2) use the same rules (mainly Subchapter K rules) for the tax-option corporations that are used for corporations included in the mandatory system, with whatever modifications are necessary. Either approach would provide an adequate set of rules for the tax-option corporations. However, the Subchapter S approach would be easier to apply to corporations with numerous shareholders, whereas the Subchapter K approach would make it unnecessary to maintain a complete set of separate rules for tax-option corporations. Since it is not essential to the mandatory system that semi-public corporations be given the partnership option, specific differences between these two approaches are not examined in this study.

CHAPTER VIII

SUMMARY AND CONCLUSIONS

This study was undertaken to determine the desirability and feasibility of replacing the existing system of taxing closely held corporations (both the corporate tax method and Subchapter S) with a partnership-type tax system that would be applied to closely held corporations on a mandatory basis. In examining both the existing system and the proposed mandatory partnership system, consideration was given equity, administrative and compliance factors, and economic consequences. In addition, the constitutionality of the mandatory partnership approach was considered.

The major findings of this study are presented in the following sections in which the existing system is compared with the mandatory partnership system:

Equity. The mandatory partnership approach clearly would provide a more equitable means of taxing the income of closely held corporations than that provided by the existing system. The two most widely accepted standards of equity in federal income taxation are horizontal equity and

ability to pay.

The existing system of taxing closely held corporations deviates significantly from both of these standards. With respect to horizontal equity, shareholders of closely held corporations taxed under the corporate tax method are not accorded tax treatment similar to that accorded sole proprietors and partners--persons in substantially similar circumstances. In addition, the corporate tax method imposes a tax on corporate income largely without regard to the ability to pay of shareholders and taxes only distributed corporate income directly to shareholders. Subchapter S, which is used by approximately 12 percent of business corporations, mitigates these inequities only to a minor extent.

On the other hand, the mandatory partnership system would bring the taxation of closely held corporations into conformity with both horizontal equity and ability to pay. Owners of privately held businesses (whether the businesses were incorporated or unincorporated) would be accorded similar tax treatment, and the income (whether distributed or not) of closely held corporations would be included in the determination of the individual tax liabilities of shareholders.

Administrative and compliance factors. The mandatory partnership tax system would provide substantially less

opportunity for tax avoidance than that provided by the existing system. The unity of ownership and control in closely held corporations precludes applying the corporate tax method to these corporations in a straightforward manner; the prevalance of tax-avoidance practices and counteractions by the Internal Revenue Service in areas such as unreasonable compensation, thin capitalization, accumulated earnings, and multiple corporations attest to this fact. Subchapter S has made some contribution to the elimination of problems in these areas when the option has been used. However, the opportunity provided by Subchapter S to change tax forms and to shift back and forth between forms (within prescribed limits) has added another dimension to tax manipulation. Under the mandatory partnership tax system, there would be little, if any, opportunity to engage in the kind of tax maneuvering associated with the existing system of taxing closely held corporations. In addition, adoption of the mandatory system would not result in substituting other major opportunities for tax avoidance for the present variety.

On the other hand, an adequate system of tax rules for the mandatory system would contain provisions and prescribed tax accounting practices that are at least as complex as those contained in the existing system of taxing closely held corporations. In fact, if the tax rules in Subchapter

K were used as the principal components of the mandatory system--in conjunction with special rules for keeping corporations in the mandatory system, multiple corporations, multiple classes of stock, corporations to be given an option to be taxed like partnerships, and other special areas--the mandatory approach probably would be more burdensome than the existing system in terms of compliance problems.

Combining diverse administrative and compliance factors such as the negative effects on taxpayer morale associated with tax manipulation, enforcement problems, resources consumed in tax planning (including business form selection) and compliance problems, a net overall improvement in the administrative and compliance area would most likely result from the adoption of the mandatory partnership system.

Economic consequences. Although the economic effects of replacing the existing system of taxing closely held corporations with the mandatory system are uncertain, the most probable effects appear to be the following: (1) no significant change in total tax revenue (probably less than 2 percent of income tax receipts); (2) a slight net disincentive to form, work hard in, and expand small business enterprises owned by individuals in upper-middle and high tax brackets; (3) a significant reduction in the funds

available after taxes to finance the growth of some small corporations (perhaps as many as 200,000 small corporations, including many of the nation's most promising growing enterprises); and (4) the elimination of the incentive to hoard funds (which could be invested more profitably elsewhere without the corporate tax method) in closely held corporations. With the exception of the change in tax revenue, it would be virtually impossible to arrive at fairly accurate quantitative estimates of these effects. However, it does appear that the mandatory partnership system would, on the whole, have less desirable economic effects than the existing system.

Constitutionality. There is, of course, no question as to the constitutionality of the existing system of taxing closely held corporations. Whether or not the partnership tax method could be applied to closely held corporations on a mandatory basis without a constitutional amendment is questionable. The weight of informed legal opinion indicates that the mandatory partnership approach would not require constitutional amendment. However, the constitutional issue will probably never be resolved until the mandatory approach is attempted.

Recommendations. It appears that the mandatory partnership approach would, on the whole, provide a more desirable approach to taxing the income of closely held

corporations than that provided by the existing system. Moreover, the mandatory partnership approach appears to be no less feasible than the existing system. The analysis contained in this study is not, however, sufficient to warrant recommending that the mandatory partnership approach be adopted without further study. Numerous areas examined briefly in this study would have to be examined in considerable detail before a decision with respect to adoption could be adequately supported.

Among the areas warranting further study are: (1) patterns of ownership of business corporations (with the exception of publicly held corporations, comparatively little is known about the ownership of the bulk of the corporate population); (2) the formulation of specific tax rules to be contained in the mandatory system; (3) the feasibility of either eliminating or greatly restricting the use of the corporate surtax exemption, in conjunction with the adoption of the mandatory partnership tax system; and (4) probable effects on the growth of small businesses that would result from the adoption of the mandatory system. In addition, before the mandatory system could be adopted, the system would have to be coordinated with (1) provisions for taxing foreign operations and (2) various forms of special tax treatment accorded

corporations engaged in certain operations (small business investment companies, nonprofit organizations engaged in taxable business activities, insurance companies, etc.). A detailed examination of all these areas is beyond the scope of a single study.

In conclusion, the mandatory partnership approach to taxing closely held corporations is worthy of far more serious consideration than it has received in the past. Certainly there are no obvious reasons for rejecting this approach without further consideration. In view of all the problems associated with the existing system of taxing closely held corporations, further examination of the mandatory partnership approach is warranted.

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