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ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO INCOME TAX STATUS

By JUDSON A. CRANE*

Within recent years Congress has manifested a purpose to promote a greater amount of free competition by legislation in behalf of the interests of small business concerns.¹ In 1953 a new federal agency was created under the name of Small Business Administration. The function of this agency is to make loans to small business concerns. In 1958 Congress authorized the creation of Small Business Investment Companies, for the purpose of making loans to small business concerns by the use of privately subscribed capital as well as federal contributions.²

A further aid to small business has been amendments of the Internal Revenue Code designed to permit choice of form of business association, in certain cases, without regard to the income tax consequences. In the Internal Revenue Code of 1954 it was provided that certain unincorporated business enterprises might elect to be taxed as domestic corporations.³ In 1958 there was enacted as part of the Technical Amendments Act provision for certain small business corporations to elect to be taxed as partnerships.⁴ This presents the problems of (1) whether it is advantageous for an existing corporation, which is eligible, to make such an election, and (2) whether it is advantageous for sole proprietorships or partnerships to incorporate

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¹ 67 Stat. 232 (1953), 15 U.S.C. §§ 631-51 (1957).

² Small Business Investment Act of 1958, 72 Stat. 689 (1958), U.S. Code Cong. & Ad. News 3535.

³ INT. REV. CODE OF 1954, § 1361. (Hereafter, unless otherwise indicated, all citations to sections will have reference to the Internal Revenue Code of 1954.) No regulations have been promulgated by the department but only temporary rules. T.D. 6124 § 23, 4 CCH 1958 STAND. FED. TAX REP. ¶ 4846. This was apparently a special act designed to meet a particular situation. Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1149 n.4(i) (1957). The purpose may have been to retain earnings in a partnership, the members of which were in higher brackets than those of corporations. Judge Murdock of the Tax Court, quoted in 6 CCH 1958 STAND. FED. TAX REP. ¶ 8993, at 66,985-86. The act, as originally adopted in 1954, contained no provision for termination of the status. Such provision was supplied by § 63 of the Technical Amendments Act of 1958, 72 Stat. 1606, , 1958 U.S. Code Cong. & Ad. News 6610.

⁴ §§ 1371-77. Temporary rules have been published as T.D. 6317, 6 CCH 1958 STAND. FED. TAX REP. ¶ 6716. Form of election with instructions is published as Form 2553, 6 CCH 1958 STAND. FED. TAX REP. ¶ 6725.

and exercise the election. Solution of such problems requires a careful consideration of the new statute in the background of the existing provisions of federal and state income tax laws, and a consideration of the incidents of the various forms of business associations.

Subchapter S—Election of Certain Small Business Corporations as to Taxable Status—begins with a definition of “small business corporation.”⁵ It means a corporation which is not a member of an affiliated group as defined in section 1504. It must have not more than ten shareholders. This suggests the “close corporation,” an institution which has received considerable attention of late in legal periodical literature.⁶

It must not have as a shareholder a person (other than an “estate”) who is not an individual. Some guide to the meaning of the word “individual” is afforded by the report of the Senate Committee on Finance wherein it is stated, with reference to ceasing to be a small business corporation, that

if an eleventh person or a nonresident alien becomes a shareholder in the corporation, if a *corporation, partnership, or trust* becomes a shareholder, or if another class of stock is issued by the corporation, the election is thereby terminated.⁷ (Emphasis added.)

Apparently it is intended that eligible shareholders exclude trustees, which may mean any type of fiduciaries other than “an estate.” The exception of estates presumably is inserted so as to preserve the status of the electing corporation during the period of administration of the estate of a deceased shareholder. It may be impossible to qualify as an electing small business corporation a family corporation in which shares are held by trustees, guardians, or custodians for the benefit of minors.⁸ There is also the problem of whether in the case of shares which are community property there is one shareholder or two, if one spouse is the registered owner.^{8a}

The small business corporation cannot have a nonresident alien as a shareholder. If a shareholder in a qualified electing corporation, such as Grace Kelly, were to marry and become a resident citizen of a foreign

⁵ § 1371.

⁶ A very full list of recent articles dealing with the close corporation appears as appendix A following an article by O'Neal, *A Seminar in Close Corporations*, 11 J. LEGAL ED. 237, 241-43 (1958). A series of articles comparing the American close corporation with its British, German, Dutch, and Swiss equivalents appears in 14 BUS. LAW. 215-78 (1958).

⁷ 1958 U.S. Code Cong. & Ad. News 7014.

⁸ See California Gifts of Securities to Minors Act, codified as CAL. CIV. CODE §§ 1154-64. This and similar statutes are discussed later in this article. Technical Information Release 113, 6 CCH 1959 STAND. FED. TAX REP. ¶ 6221 indicates that the minor would be regarded as the shareholder, in cases of guardianships or custodianships, as he is the legal and beneficial owner.

^{8a} TIR 113 takes the position that where shares are community property there are two shareholders. See Comment, 45 A.B.A.J. 81, 83 (1959) to the effect that this is incorrect where shares are registered in the name of one of the spouses only.

country, the corporation would cease to be qualified, and its election would terminate.

The corporation must not have more than one class of stock. But there is nothing in the statute to disable the electing corporation to issue bonds and debentures. Under the corporation laws of many states bondholders can be given voting and other rights usually possessed by shareholders.⁹

If election is made by all the shareholders on or before the first day of the corporation's taxable year in the manner prescribed by the Secretary or his delegate, the corporation is not subject to the usual taxes on its income,¹⁰ but the tax liability is imposed upon the shareholders. The income of the corporation, whether distributed as dividends or not, is included in the gross income of the shareholders, pro rata.¹¹ The election is effective for the taxable year and succeeding years until revoked or terminated.¹² It may be revoked by the consent of all of the shareholders.¹³ The election can be terminated in several ways. First, by anyone becoming a new shareholder who does not consent to the election.¹⁴ Second, if the corporation ceases to be a small business corporation, as defined above.¹⁵ A third cause

⁹ CAL. CORP. CODE § 306; PA. STAT. ANN. tit. 15, § 2852-317 (1933) [hereinafter cited as Pa. Bus. Corp. Law].

¹⁰ § 1372(a)(b).

¹¹ § 1373. The corporation's income is determined for the purpose of passing it on to shareholders as their gross income without regard to corporate net operating loss carry-backs or carry-overs under § 172.

The shareholder is not allowed the usual dividends received credit. § 1375(b).

The shareholder may return as a deduction his pro rata share of the net operating loss of the corporation during the tax year, but only to the extent of the proportion of the days of the corporation's year during which he was a shareholder. This prevents a transfer of the benefit of net loss deduction from a shareholder to a transferee just before the end of the taxable year to make it available to the transferee. § 1374. The amount of net operating loss which can be taken by a shareholder is limited to the adjusted basis of his shares. § 1374(c)(2). In determining the basis of his shares, undistributed income treated as shareholder's income under § 1373(b) is included. § 1376(a). The basis is reduced by his share in net operating loss. § 1376(b).

In family corporations, the Secretary can reallocate dividends or income allocated to the shareholders if necessary to reflect the value of services rendered to the corporation by such shareholders. § 1375(c). "Family" is defined in § 1704(e)(3) as including one's spouse, ancestors and lineal descendants. Compare § 704(e)(2) permitting a reallocation of income as between partners within the family group, as defined, so as to make proper allowance for services in producing the income. The intent of the statutes appears to be to prevent income-splitting for tax mitigation as between close members of the family without regard to services as the source of income. This is of little significance in the case of a husband and wife who file a joint return, but it may be of significance in cases of parent and child who are fellow shareholders. Reallocation would not appear to be called for as "necessary in order to reflect the value of services" if the active working shareholders were paid reasonable salaries or wages. Compare § 162(a)(1) permitting deduction by an employer as trade or business expense of "a reasonable allowance for salaries or other compensation for personal services actually rendered."

¹² § 1372(d).

¹³ § 1372(e)(2).

¹⁴ § 1372(e)(1).

¹⁵ § 1372(e)(3).

of termination is when the corporation in any taxable year derives more than eighty per cent of its gross receipts from sources outside the United States.¹⁶ Fourth, the election is terminated if the corporation in any taxable year has gross receipts, more than twenty per cent of which are in the nature of personal holding company income, such as royalties, rents, dividends, interest, and gains on sales or exchanges of stock or securities.¹⁷

Advantages and Disadvantages of Election

The outstanding advantage of election to become a small business corporation available to an existing corporation which can qualify is the avoidance of double taxation. This is particularly true of a corporation which currently distributes all or substantially all of its income. But double taxation of corporate income and of shareholders' dividends can be avoided to a considerable extent in the case of the small corporation, in which all of the shareholders participate in management. Setting salaries and other compensation by shareholders' agreement so as to absorb earnings will leave little corporate profit subject to tax.

Suppose the shareholders are in lower income tax brackets than the corporation as a taxpayer would be. If it is desired to retain income to a point where the corporation would risk liability for the penalty tax on accumulated earnings beyond the needs of the business, a tax saving is effected by an election. Once a tax is paid by the shareholders on the corporate income there is no further tax, whether the income is distributed sooner or later.¹⁸ As corporate operating losses can be attributed to the shareholders in an electing corporation the shareholders may be benefitted taxwise by offsetting the corporate losses against their income from other sources.¹⁹

There are some apparent disadvantages in the electing small business corporation. It is somewhat fragile. If shares of a member are transferred to one who does not elect to consent to being a member of the small business corporation the election terminates.²⁰ This can be guarded against by comprehensive agreements among the shareholders, preferably inserted in the articles and noted on the stock certificates, regulating the transfer of

¹⁶ § 1372(e)(4).

¹⁷ § 1372(e)(5). This is more rigid than the definition of a personal holding company, § 542, which applies where eighty per cent of gross income is personal holding company income as defined in § 543.

¹⁸ § 1377(a).

¹⁹ § 1374. The shareholder who transfers his shares within the taxable year of the corporation is allowed to take a loss only to the extent of a part of the corporate loss proportioned to the number of days he was a shareholder. § 1374(c). The shareholder, but not the corporation, can carry over his loss in excess of the basis of his shares to a subsequent year. § 1374(d).

²⁰ § 1372(e)(1).

shares.²¹ If such agreements create an option in the corporation, it can only be exercised if the corporation has an earned surplus sufficient to pay for the shares.²² If it is an option to other shareholders they may not be financially able to meet the price. If the corporation needs more capital and cannot raise it from present shareholders, it may be difficult to find a congenial outsider who will come in, even if there is a vacancy in the maximum number of ten shareholders.²³

Circumstances may arise with respect to the income of one or more shareholders and the tax brackets they are in, so that they may desire to terminate the election. The regular way to do this is by unanimous consent.²⁴ Otherwise the shareholder could terminate unilaterally by selling one or more of his shares, unless transfer is restricted. Or he could accomplish the same end by the drastic process of becoming a nonresident alien.²⁵

Accounting problems of the corporation will be increased. There is no likelihood that the states will follow the lead of Congress and establish a separate tax treatment for the small business corporation. Returns for tax purposes to the state will continue under the present requirements, and corporate income taxes will be exacted.

Not only is it necessary to maintain different accounting methods for federal and state corporate income tax returns, but there may be some confusion in keeping the shareholder's individual records and preparing his returns where the corporation's fiscal year is different from that of the shareholder. The shareholder is charged with income not previously distributed as dividends as of the date of the end of the corporation's fiscal year.²⁶ For example, if the corporation's fiscal year ends January 1, 1959, it is as of that date that the shareholder is in constructive receipt of income, though the greater part of it may have been earned in 1958. If the shareholder's tax year corresponds to the calendar year and ends December 31, 1958, his return of this income is not due until April 15, 1960. If it is necessary to file a revised statement of estimated taxable income and the shareholder does not, he may become subject to a penalty when he files his final return.²⁷ The shareholder is subject to tax on a corporate long-term capital gain.²⁸ But he is not entitled to the benefit of the dividends received credit.²⁹

²¹ CAL. CORP. CODE §§ 501(g), 2403. See O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952); Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 VA. L. REV. 229 (1951).

²² CAL. CORP. CODE § 1707.

²³ The eleventh shareholder would cause a termination of election. §§ 1371(a), 1372(e)(3).

²⁴ § 1372(e)(2).

²⁵ §§ 1371(a), 1372(e)(2).

²⁶ § 1373(b).

²⁷ See §§ 6015(e), 6073(c), providing for filing of amendments of declarations of estimated tax.

²⁸ § 1375(a).

²⁹ § 1375(b).

In cases of shareholders constituting family groups a shareholder may be charged with taxable income in excess of his pro rata share of corporate earnings if this does not adequately reflect the value of his services to the corporation in producing its income.³⁰

If an existing corporation has had a net operating loss which it could carry over into succeeding years it should be borne in mind that if it elects to become a small business corporation there is no carry-over of prior losses. Nor can the small business corporation carry over losses incurred while in that status.³¹ Operating losses are prorated among the shareholders in proportion to the number of days of the corporation's fiscal year that he is or was a shareholder.³² A transfer of his shares does not carry with it the accumulated operating loss allocable to the transferor.³³ But the one who is a shareholder at the end of the corporation's fiscal year is charged with the corporation's undistributed income of the year.³⁴ There is provision for passing the corporation's long-term capital gains to the shareholders as income, but no corresponding provision for passing over long-term capital losses.³⁵

It appears that in considering whether to elect to become a small business corporation, aside from the questions of eligibility, present and prospective, consideration should be paid to a number of factors—the present and foreseeable tax brackets of the corporation and of each of its shareholders; whether there are accrued operating losses capable of being carried forward; whether it may be desirable to add new capital by issue of shares to other than the present shareholders; whether, if shareholders are in high income tax brackets, it may be desirable for the corporation to pay a tax on its income and withhold distribution for purposes such as retirement of debts, future expansion or other reasonable needs of the business not constituting accumulated taxable income.

Advantages and Disadvantages of a Sole Proprietor or Partnership Becoming a Small Business Corporation

Not every proprietor or partnership can carry on his or its business as a corporation. Public policy as to certain professions is expressed in statutes which preclude their being carried on by corporations.³⁶

Consideration must be given to expenses involved in incorporation. There are costs of having attorneys prepare and file articles, and there are

³⁰ §1375(c).

³¹ §§ 1377, 1373(d).

³² § 1374.

³³ § 1374(c).

³⁴ §1373(b).

³⁵ § 1375(a).

³⁶ See, e.g., CAL. BUS. & PROF. CODE §§ 1627 (dentists); 2008 (physicians); 3103 (optometrists); 6125 (attorneys).

filing fees. If no public offering of securities is involved it is not necessary to file a registration statement with the SEC under the Securities Act of 1933.³⁷ But before shares of stock can be issued in California even without a public offering, it is necessary to secure a permit under the Corporate Securities Law.³⁸ While federal corporate income taxes may be avoided, as has been explained, state corporate income taxes will be imposed as well as personal income taxes on dividends distributed to shareholders, and accounting procedures will be magnified.^{38a}

The more obvious advantages of incorporation of a business include immunity of shareholders from personal liability beyond payment of their share subscriptions, perpetual succession, concentration of management, and the possibility of certain fringe benefits for shareholders who are officers or employees, such as pensions and group insurance.

As to immunity from personal liability, if the credit rating of the corporation is not satisfactory persons dealing with it may insist on personal obligations of officers or shareholders guaranteeing corporate obligations. If the corporation is found to have been inadequately financed a court at the instance of a creditor may disregard the corporate entity and treat those who are making use of it as joint adventurers personally liable.³⁹ In dealings with third parties the conduct of management may be so far ambiguous as to permit the third person to establish that he gave credit to the managers and not to the corporation.⁴⁰ The business may be so informally carried on by the controlling shareholders as if it were his or their own business that the courts will hold that the corporate entity is merely the *alter ego* of the controlling shareholders.⁴¹

What about ending the business? A sole proprietor can of course quit business whenever he desires. But there are significant differences between the position of an owner of a minority interest in a business, depending upon whether the business is a partnership or a corporation. A partnership

³⁷ 68 Stat. 684 (1954), 15 U.S.C. § 77d (1952), as amended, 15 U.S.C. § 77d (Supp. IV, 1957).

³⁸ CAL. CORP. CODE § 25500.

^{38a} Form 1120-S, with accompanying instructions, shows the great amount of detail as to the financial transactions of the small business corporations which must be included in the required information return.

State taxing authorities may accept the figures set forth in the return to the federal Internal Revenue Service as evidence of the corporation income for purposes of state income taxation. See announcement of Pennsylvania Department of Revenue appearing in *Pittsburgh Legal Journal*, December 27, 1958, p. 9. In Pennsylvania it is required that where taxpaying corporations regard income taxes paid by shareholders in electing corporations as affecting net earnings of the corporation for purposes of valuation for capital stock and franchise tax purposes, relevant information as to such payments must be submitted to the Department.

³⁹ *Automotriz del Golfo de California v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957).

⁴⁰ *Wittman v. Whittingham*, 85 Cal. App. 140, 259 Pac. 63 (1927), commented on by Fuller, *One-Man Corporations*, 51 HARV. L. REV. 1373, 1379 (1938).

⁴¹ *Flying Tiger Line, Inc. v. United States Aircoach*, 51 Cal. 2d , 331 P.2d 37 (1958).

is generally for a limited term of years. A prior dissolution is possible by unanimous consent, and even without consent of copartners a partner has the power to wrongfully dissolve.⁴² A corporation exists in perpetuity unless dissolved by decree of court or by vote of holders of fifty per cent or more of the voting shares.⁴³ The minority shareholder in the small business corporation cannot force a dissolution unless he comes within the conditions set forth by statute for dissolution by decree of court. He probably cannot find a ready market for his shares at what he considers a fair price, particularly if there are restrictions on the transfer of shares. On the other hand, the minority shareholder is subject to dissolution at the will of the majority without the protection afforded to a partner in a partnership whose term has not yet expired.⁴⁴ There is a subjective advantage to the shareholder who can contemplate that his death will not result in liquidation of the business as might result in a partnership unless provision is made in articles for continuation of the business, or the survivors agree with the decedent's estate to buy out his interest.⁴⁵ The existence of the corporation is unaffected by the death of a shareholder. His shares become a part of his estate. His personal representative, succeeding to his shares, may become a shareholder in the electing corporation, apparently as a unit. This would not increase the number of shareholders, whether the representative be one or more persons or a corporate fiduciary, under the provision that an "estate" can be a consenting shareholder.⁴⁶

An incident of perpetual succession is the transferability of shares. A shareholder can sell his shares, if he can find a purchaser, and the transferee is in the same position as the transferor. He can pledge his shares with probably greater facility than can a partner pledge his interest. But there may be restrictions on transfer which otherwise might bring in uncongenial or hostile shareholders or some who would not consent to the continuance of the election. It is therefore desirable, as in other close corporations, that there be restrictions comprehensive enough to include involuntary as well as voluntary transfers, giving other shareholders options to purchase.⁴⁷

⁴² UNIFORM PARTNERSHIP ACT § 31; CAL. CORP. CODE § 15031.

⁴³ CAL. CORP. CODE §§ 4600, 4650-51; Pa. Bus. Corp. Law §§ 1101-12.

⁴⁴ UNIFORM PARTNERSHIP ACT § 38(2); CAL. CORP. CODE § 15038(2). Where a corporation is dissolved by act of majority shareholders in fraud of the interests of the minority they may have a right to damages. See *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941); Comment, *The Fiduciary Relation of the Dominant Shareholder to the Minority Shareholders*, 9 HASTINGS L.J. 306 (1958).

⁴⁵ Partnership articles can provide in anticipation of death of a partner for the continuance of the business with an interest in profits in the decedent's estate or members of his family, or for the purchase of the decedent's share and interest by the survivors. See CRANE, PARTNERSHIP § 90a (2d ed. 1952).

⁴⁶ § 1371(a)(2).

⁴⁷ CAL. CORP. CODE §§ 305(c), 501(g); Pa. Bus. Corp. Law §§ 204(12), 304. O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952).

Such restrictions should be included in articles and noted on the share certificates.⁴⁸ In a partnership partners have powers to act for the firm and are normally expected to participate in carrying on the business. This can be varied by agreement which would usually be expressed in articles. Differences as to policy are decided by majority vote, each partner having one vote unless the agreement provides otherwise.⁴⁹

Such fundamental matters as change of purposes, increase of capital contribution, or admission of a new partner require unanimous consent. In a corporation powers as to management are delegated to a board of directors and officers. In the small business corporation it seems to be intended that shareholders render services, for in allocating taxable income allowance must be made for relative services.⁵⁰ Matters coming before boards of directors and shareholders' meetings are commonly decided by majority vote, but articles may provide for more than a majority for effective action.⁵¹ Preincorporation agreements between incorporators may, according to modern authorities, be effective.⁵² An appropriate matter for preincorporation agreement among all the shareholders would be the annual declaration and distribution of some dividends to enable shareholders to meet the income tax liability imposed on them by reason of corporate earnings whether distributed or not. It might seem proper to agree that at least thirty per cent of corporate earnings be distributed to shareholders each fiscal year. Otherwise shareholders might be subject to a burdensome liability based on constructive receipt of income. As to matters which require amendment of articles, such as changes of purposes or the issuance of new shares, it would seem desirable to have written preincorporation agreements, or provide for more than a majority vote of shares to effect such changes by amendments.

Stability and continuity of control may be effected by agreements for

⁴⁸ UNIFORM STOCK TRANSFER ACT § 15; CAL. CORP. CODE § 2403.

⁴⁹ UNIFORM PARTNERSHIP ACT § 18; CAL. CORP. CODE § 15018.

⁵⁰ § 1375(c).

⁵¹ Directors, CAL. CORP. CODE § 817; Pa. Bus. Corp. Law § 402(5). There are many statutes permitting articles to contain provisions requiring more than majority vote for certain actions, such as amendments of articles, mergers, sale of assets. Lacking such specific provisions it is submitted that general provisions as to what may be included in articles should be construed in view of the present trend of legislation to permit incorporation in articles of requirements for more than majority share vote for certain specified actions. See CAL. CORP. CODE § 305(c); Pa. Bus. Corp. Law § 204(12). See Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L.Q. 131, 162 (1951); O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONTEMP. PROB. 451, 457 (1953).

⁵² *Elsbach v. Mulligan*, 58 Cal. App. 2d 354, 136 P.2d 651 (1943); *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936); *DeBoy v. Harris*, 207 Md. 212, 113 A.2d 903 (1955), noted in 44 CALIF. L. REV. 590 (1956) and 69 HARV. L. REV. 565 (1956).

the pooling of voting power⁵³ or by proxies coupled with an interest.⁵⁴ Whether a voting trust can be used would depend on whether the voting trustee would be regarded as an individual, eligible to be a shareholder, or whether the holders of the voting trust certificates would be regarded as shareholders who have given proxies and delegated to the trustee the duty of collecting and distributing dividends as declared.⁵⁵ If the latter view is adopted the certificate holders would be taxable on their pro rata shares of undistributed income as of the end of the fiscal year of the corporation. The number of certificate owners would be counted in determining whether the number of shareholders exceeded the maximum of ten. As certificates were transferred the transferees would have to execute consents, as in the case of transfers of registered ownership.

Joint ownership of shares presents another problem. The corporation may treat the block of shares as a unit, disburse one dividend check, send out one notice of meetings, and issue one certificate. Corporation statutes may provide how such shares shall be voted.⁵⁶ It seems that in any case, except where there are co-executors or co-administrators of an estate, there are as many shareholders as there are joint owners. This seems clearly so if they are tenants in common. It should be so in the case of tenants by the entirety, except in a jurisdiction which adheres to the old common law notion of marital unity. If shares standing in the name of a spouse are the proceeds of an investment of community property it does not seem that the registered owner is to be regarded as a trustee despite the latent interests of the other spouse, or that it is to be deemed that there are two shareholders. The instructions for filing Form 1120-S do not call for information as to the marital status of shareholders.⁵⁷

The corporate form of association offers advantages over partnerships in matters of fringe benefits. The corporation can set up pension trusts,

⁵³ *Smith v. San Francisco & No. Pac. Ry.*, 115 Cal. 584, 47 Pac. 582 (1897); *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 29 Del. Ch. 610, 53 A.2d 441 (1947); *Sturdy, The Significance of "Form" and "Purpose" in Determining the Effectiveness of Agreements Among Stockholders to Control Corporate Management*, 13 BUS. LAW. 283 (1958). *O'Neal, Protecting Shareholders Control Agreements Against Attack*, 14 BUS. LAW. 184 (1958).

⁵⁴ *Ecclestone v. Indialantic, Inc.*, 319 Mich. 248, 29 N.W.2d 679 (1947); *Deibler v. Charles H. Elliott Co.*, 368 Pa. 267, 81 A.2d 557 (1951).

⁵⁵ Holders of voting trust certificates under the CAL. CORP. CODE are entitled to inspection of books (§ 3003), to institute a derivative suit (§ 834), and, unless otherwise specified, to terminate the voting trust by vote of the holders of a majority in interest of the beneficial interests (§ 2231).

⁵⁶ CAL. CORP. CODE § 2223; Pa. Bus. Corp. Law § 507, providing that in case of even division the vote shall be divided equally.

⁵⁷ Instructions for the 1958 Form 1120-S, U.S. Small Business Corporation Return of Income, reproduced in 6 CCH 1958 STAND. FED. TAX REP. ¶ 6827.

If the spouse in whose name shares are registered is a trustee for the community he may be barred as not being an "individual." If such stock is to be treated as jointly owned there are two shareholders. Until the question is decided by decisions the status of a married shareholder in a Small Business Corporation is in some doubt. *But see* TIR 113, note 8a *supra*.

retirement annuities, stock bonus and profit-sharing trusts, and plans for medical and hospital care for employees including shareholders.⁵⁸ Stockholder-employees, even if officers, may be included in provisions of social security benefits and unemployment insurance.⁵⁹ A stockholder-employee may be entitled to workmen's compensation benefits, though if he is an officer it may depend on the actual powers and duties of his office.⁶⁰ Because a shareholder or officer is not a principal, as such, if injured on the job, he would not be subject to the defense of imputed contributory negligence, as in the case of a partner.⁶¹

If the shareholders are charitably minded the corporation can claim a deduction for corporate charitable gifts,⁶² and the shareholders also can claim a deduction for their individual gifts.

It has been suggested that one advantage of the corporation is to facilitate noncharitable gifts, such as to children or other relatives. Gifts of interests in partnerships have always been difficult from the income tax angle.⁶³ Gifts of shares of stock do not run into the same difficulty, provided the donee is capable of taking the gift. This is a problem in the case of a minor child. In the ordinary corporation the transfer can be made to the infant, and if he is of sufficient years of discretion the corporation may recognize him as a shareholder.⁶⁴ Or it may deal with his guardian.⁶⁵ Or the gift may be made to a trustee for the benefit of the infant. The difficulty with gifts to a minor of shares in a small business corporation is that the transferee must execute a consent to the continuance of the election. If the

⁵⁸ § 404.

⁵⁹ §§ 3121(d)(1), 3306(i).

⁶⁰ 7 HASTINGS L.J. 215 (1956); Annot., 81 A.L.R. 644 (1932).

⁶¹ Buckley v. Chadwick, 45 Cal. 2d 183, 288 P.2d 12 (1955).

⁶² § 170.

⁶³ Numerous efforts were made to mitigate income tax liabilities by formation of family partnerships, particularly between husband and wife. Following the case of Commissioner v. Tower, 327 U.S. 280 (1946), the taxing authorities were reluctant to recognize a partnership where the alleged partner's interest was a gift and she did not render substantial services. This arbitrary approach was changed by the decision in Commissioner v. Culbertson, 337 U.S. 733 (1949), a case involving father and children, in which the emphasis was laid on the matter of bona fide intention to be partners, rather than on the donative source of the capital employed. As to husband and wife partnerships the problem was largely solved by the joint return privilege conferred in 1948. See §§ 2, 6013. Then in 1951 the Internal Revenue Code was further amended to provide for recognition of partnerships, where capital was a material income-producing factor, whether a partner's interest was acquired by purchase or gift, with the proviso that allocation of taxable income should be determined with allowance of reasonable compensation for the services of the donor-partner and his capital contribution. § 704(e). Extensive regulations under this section make it necessary that there should be a bona fide intention to form a partnership and carry on business without undue restrictions upon the rights of partners in management and income distribution and use of income allocated to a minor partner for his support for which the donor partner is legally responsible. Treas. Reg., § 1.704-1 (1957).

⁶⁴ CAL. CORP. CODE § 2221.

⁶⁵ CAL. CORP. CODE § 2221.

donee is of tender years that is of course impracticable. If the gift is to a guardian or trustee the question arises as to whether the new shareholder is an "individual." It has been suggested that in California, Pennsylvania, and other states which have adopted a Gifts of Securities to Minors Act,⁶⁶ the gift might be effectively made without disturbing the status of the corporation. While these acts state that the donee minor is the legal owner of the stock the registration is in the name of the custodian. He is clearly holding the record title and exercising the rights of shareholder in a fiduciary capacity. If trustees are ineligible⁶⁷ it would seem that a custodian is likewise ineligible. If shares can be held in this way it would present a case for reallocation of taxable income in the light of relative worth of services rendered. If the income is in whole or in part used for support of the child, and that is a legal obligation of the donor, the income so used might be taxable to the donor.⁶⁸

It is possible that where a gift has been made in compliance with the Gifts of Securities to Minors Act the Internal Revenue Service will treat the minor as the real shareholder and the custodian as merely an agent to whom has been delegated powers or representation as to executing necessary consents, as well as power to vote and receive and expend income.⁶⁹

Conclusion

There are many matters to be carefully considered in determining whether to elect to be taxed as a small business corporation other than the advantages of securing limited liability and perpetual succession and the avoidance of double taxation. There are advantages and disadvantages as compared to ordinary corporations, partnerships, and sole proprietorships. Many of them have been pointed out here. The new tax law is no panacea for the financial problems of all small businesses. The application of the law of partnerships and corporations as well as taxation to any business must be appraised. In each situation the advantages and disadvantages merit careful study by tax lawyers, accountants, and lawyers familiar with fields other than tax law. There are many doubtful questions which can only be clarified in the course of time by regulations and judicial decisions, or perhaps by amendment of the statute.

⁶⁶ CAL. CIV. CODE § 1154; Pa. 1957 P.L. 358. It appears the act, which in substantially similar form has been adopted in several states, originated in the members of the New York Stock Exchange. It was devised to facilitate gifts of securities to minors, which might be productive of a greater income than the common gifts of savings bonds and savings deposits without the expense incident to trusteeships and guardianships. See comments in 44 CALIF. L. REV. 569 (1956); 69 HARV. L. REV. 1476 (1956); 54 MICH. L. REV. 883 (1956).

⁶⁷ 1958 U.S. Code Cong. & Ad. News 7014.

⁶⁸ § 677(b).

⁶⁹ This is the solution indicated by TIR 113, 6 CCH 1959 STAND. FED. TAX REP. ¶ 6221.