The Choice of Form for the Family Owned Business

Bauer E. Kramer
Alvin Ziegler Jr.
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By Bauer E. Kramer* and Alvin Ziegler, Jr.**

ONE OF the most interesting problems to challenge the drafting skills of the business lawyer is that of choice of form and manner of organization of a substantial, family owned business. Owners with different ages, life expectancies, financial resources, business experience, skills, abilities, and personalities must be brought within a business form that will best balance the legal benefits and detriments, tax advantages and disadvantages, as well as the estate planning program of the family. The process will often result in the selection of a form less than ideal, but the best working compromise with desired results.

This article deals with some of the problems that arise in choice of form and organization. To serve as a basis for discussion, we assume a family—the Smiths—of husband, wife and three adult children. Perhaps the relationships and problems of our Smith family have not all occurred at one time in selection of form for a family business, but all of them occur frequently in this context, and in that sense the Smith family presents a typical case. It is hoped that the problems and discussion presented will have a relevance broader than the assumed factual basis.

The ability to select a form of doing business which will yield reasonably predictable results is one of the most important skills in planning for the family business of whatever size. It is usually more important to provide a solution which can be virtually certain to avoid litigable risk than to provide a form of organization which, if successful, might bring substantial tax savings. The penalty for uncertainty in the family business is often litigation which the owners of the business cannot afford; in the tax area, for instance, it would be an unusual family business which would be willing to incur the costs of a Tax Court and appellate contest unless a favorable outcome was virtually certain.

The adversary, arm's length relationships which are present among

* LL.B., Harvard Law School, 1934; Author and Lecturer, State Bar Continuing Education Program (1954); member, California Bar.
** LL.B., Harvard Law School, 1960; member, California Bar.
the owners, management, and creditors of a publicly held business are not present in the family business. Similarly, the day to day checks and balances which arise from the contact of persons with competing interests are absent. In some respects the more casual atmosphere of the family business may decrease the urgency of precise organizational planning. But the absence of recurring arm’s length relationships and contacts also works to complicate the problem of effective planning. Most of the rules of practice in business law, and particularly corporation rules, have been established with the problems of the large, publicly held company in mind. Many of these rules are not easily adaptable to the family business context where one or more persons will usually have the roles of manager, stockholder, and creditor simultaneously.

The informality of the family business may erode any carefully tailored organizational plan; planning should take into account this risk. If the parties do not act their parts, there may come a time when the status, or purported role, of the owner, manager, or creditor of the business will be subject to attack by the Internal Revenue Service, outside creditor, or other interested party. Short of such attack, dangerous uncertainties may arise which can be clearly determined only by litigation, a course which the family business planner usually abhors. This article assumes that the job of a lawyer who is advising the organization of a family business is to chart plans which at best will minimize or avoid the dangers of such uncertainties, and which at worst will provide predictable avenues for dealing with troublesome uncertainties as they arise.

Assumed Facts

Smith, a man in his late fifties, is sole proprietor of a small business known as Smith Electric Company, engaged in the sale of electrical control devices. Smith manufactures a control of his own design and sells catalog items produced by major manufacturers. The business assets consist of the offices and plant, well located in the industrial section of the city, machinery and equipment, and a substantial inventory, all current. With but minor exceptions, all depreciable property has been completely depreciated.

The business has been successful in the past, but due to competitive conditions is less so now, and each year the sale of the Smith-manufactured items represents a smaller percentage of the total sales volume. Except for the last few years, when earnings were poor,
Smith always drew and spent less than the business net income, with
the result that the business net worth has increased through the years.
Smith Electric Company has no outstanding debt. The net worth of
the business represents about three quarters of Smith’s total net worth;
his personal assets are his home, life insurance, bank accounts, and
stocks and bonds.

Smith has two sons, both married, who are employed in the busi-
ness. Son John is a graduate engineer—able—with ideas for expansion
of the company’s products into a new but related field. John has
invented and patented a small but sophisticated electric control device
for “space-age” components. Son Richard is a salesman—also able—a
happy extrovert with little interest in the managerial or engineering
aspects. Smith also has a daughter, Karen, who is married to a school
teacher and lives in Idaho. Smith’s first wife died in 1946, leaving her
estate to her husband. In 1950 Smith married his present wife Mary
who is younger than he. There are no children of the second marriage.
Relations between Smith and his wife are good, but he is disturbed
by the fact that Mary and his three children do not get along well.

Smith recognizes the need to provide ownership interests for his
two sons if they are to remain with the business. John has already had
offers from an electronics firm at considerably more than he is now
earning, plus the incentive of stock options, group life insurance, and
a profit-sharing plan. Richard could easily earn twice what Smith is
paying him as a salesman for any of Smith’s eastern suppliers or larger
local competitors. Smith recognizes the need for expansion if the
business is to survive, although he is worried about the risk inherent
in what John proposes and is hesitant to incur a substantial debt to
retool the plant and hire additional skilled technicians to manufacture
the new device.

Smith’s friends have told him that a corporation affords complete
insulation from personal liability, that there are substantial tax savings
and fringe benefits inherent in the corporate form, and that he can
minimize the double tax on corporate income paid out in dividends by
taking a large part of his contribution in debt instruments rather than
entirely in stock. They have also told him that stock affords a con-
venient instrument of periodic sales or gifts of interests to the sons
and that preferred stock is a convenient method of assuring an income
to his wife, who in all probability will survive him, and to his daughter
Karen, for whom he also wishes to make provision. Smith is strongly
oriented toward the corporate form at the time of the first appoint-
ment with his attorney.
How Much of Smith’s Property Is and Will Become Community?

One of the first areas of uncertainty which will be encountered on the assumed facts is that arising from the confusing application of community property rules to a business which begins as separate property, but which probably will owe any future appreciation in large part to personal services. The question of allocation between community and separate property of a family business would appear to be primarily an estate planning problem. The problem actually is more basic. The question of how much of the business is community is really a question of who owns what, and will be important in virtually every phase of planning for the Smith business. For instance, Smith intends to provide each member of his family an interest in the business; it is assumed that this plan will require that Smith make gifts to Karen if not to other members of the family. In order to plan (a) the amount and nature of gifts to be made to Karen, (b) Smith’s ability to make gifts of the business without Mary’s consent, and (c) the dimensions of any risk of loss of control by Smith after completion of the gifts, it will be necessary to know what part of the business is community now, and what part of the business may become community in the future.

In making a decision concerning the character of the business for the future, Smith’s advisers will meet the confusing and dangerously unpredictable principles which have been set down in this area by the California courts. If one form of business entity would work to minimize the problems in this area, this would be a factor favoring use of that form.

The basic principles of California community property law are well established, but their application to Smith’s assets is difficult. No cautious attorney would venture to advise Smith exactly how much of his estate is community now or how much may become community in the future. All property owned by a spouse at the time of marriage is the separate property of such spouse; all property purchased or otherwise obtained by a spouse in exchange for separate property becomes separate property; all of the rents, issues, and profits of separate property are separate property.¹

The trouble begins when the language of the statute regarding “rents, issues and profits” is applied to a business to which the husband contributes services as well as capital. In most cases it is clear from

the business standpoint as well as from the standpoint of community property law that any appreciation in such a business is in some part attributable to the husband's services. It is usually clear, too, that part of the appreciation of a business is attributable, or at least analogous to, a return on the capital invested in the business. In most family businesses the husband is withdrawing some part of the profits as a reward for his services periodically as the services are performed. In the family business, unlike the publicly held business in which salaries are reviewed by theoretically independent authority, the amount of property which is drawn by the husband as a "salary" or other periodic reward for his services cannot be accepted by the courts as a binding or even strongly probative measure of the value of the husband's services.

Two possible formulae for solving the allocation problem in California have been employed by the courts where the husband's personal services since marriage have enhanced the value of his separate property. The formulae were originally propounded in *Pereira v. Pereira*\(^2\) and *Huber v. Huber*\(^3\) and will hereinafter be called the *Pereira* approach and the *Huber* approach respectively.

These two methods have been well summarized in *Tassi v. Tassi*:\(^4\)

Two approaches have ordinarily been made to the allocation of earnings in such cases: 1. to allow interest on the capital investment of the business, allocate such interest as separate property, and treat the balance as community earnings attributable to the efforts of the husband (*Pereira v. Pereira* . . . ); 2. to determine the reasonable value of the husband's services in the business, allocate that amount as community property, and treat the balance as separate property attributable to the normal earnings of the business. (*Huber v. Huber* . . . )\(^5\)

Both methods are probably still acceptable under the authorities, although one has definitely been favored over the other.

In *Estate of Neilson v. Neilson*,\(^6\) the leading case on allocation of appreciation of a separate property business, the *Pereira* approach is described as the "usual method of apportionment."\(^7\) The supreme court in *Neilson*, however, failed to indicate whether in circumstances

\(^2\) 156 Cal. 1, 103 Pac. 488 (1909).
\(^3\) 27 Cal. 2d 784, 167 P.2d 703 (1946).
\(^5\) Id. at 690, 325 P.2d at 878. *Tassi* followed the second approach pointing out that the business was of a type justifying high return on capital.
\(^6\) 57 Cal. 2d 733, 371 P.2d 745 (1962).
\(^7\) Id. at 740, 371 P.2d at 748.
justifying a departure from the "usual method" the departure should be made by adopting a completely different method, the Huber approach for instance, or by raising the rate of interest to be applied to separate property as a special application of the "usual method." Most of the uncertainties then, which existed prior to Neilson in allocating appreciation of the husband-run business have survived that case.

There is no indication that the appellate courts have ever considered the adjustments required under either formula to allow for the effect of income taxes or compounding interest. When the court in Neilson says that "the usual rate for a well-secured investment" should be applied, it is by definition referring to a rate before taxes. To apply even a six per cent rate without adjustment for tax impact under the Neilson approach could have the effect of allocating the entire increment unjustly to separate property. Conversely, the Huber approach, usually considered favorable to separate property, could tilt the scales in favor of community unless appropriate tax adjustment is made. Some illustrations will show how this can operate:

(1) Assume that husband owns an interest in a closely held corporation in which he is an executive employee and that its profits before taxes equal twelve per cent on invested capital as it existed at date of marriage. Assume that the combined state and federal taxes on the corporation's income approximate fifty per cent. Assume that husband's stock had a book value of 200,000 dollars at the time of his marriage and 400,000 dollars at the time of his death twenty years later, and that book value is accepted by all concerned as market value. Under these facts, if six per cent is the proper rate "for a well secured investment," the application of a six per cent rate to 200,000 dollars (original capital) for the period of marriage will result in the entire increment being allocated to separate, whereas only half should be separate, since both community and separate were reduced by fifty per cent in corporate income taxes. If the business were of a type justifying the Huber approach, and if it could be shown that the husband's salary was 12,000 dollars a year less than what comparable executives receive in comparable employment, the effect would be to allocate the entire increment to community, whereas again it should properly be allocated half to each, with the determination being that 300,000 dollars of his business interest is the husband's separate property and 100,000 dollars is his community property.

(2) Assume the same facts as in the first illustration except that

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8 Id. at 740, 371 P.2d at 748-49.
the business is a sole proprietorship, that the husband is in a combined state and federal tax bracket of fifty per cent, and that he pays his taxes from his business drawing account. Here an even more unjust result would follow, for if the drawing account is treated as his community earnings no part of the increment would be allocated to community under either formula if the husband's income taxes exceeded 12,000 dollars per year.

Another interesting problem left unanswered by the Neilson approach is the question of whether the assumed rate of interest is simple interest or compound interest. Stated differently, is it an interest rate computed on the value of the separate property at date of marriage multiplied by the number of years of marriage, or does it recognize that earnings may have been ploughed back and that a return on invested capital requires inclusion of the annual increment?

It seems unreasonable to make no allowance for additions to capital resulting from increase in earned surplus (or net worth, if an unincorporated business). In the first illustration above, at the end of the first fiscal year following the marriage, the husband's stock would have a book value of 224,000 dollars of which 212,000 dollars would represent his separate property (at a six per cent rate) and 12,000 dollars would represent community. By leaving the profits in the business, he has enabled it to become more productive, and if he is entitled to the rate of interest on a "well secured investment" for the second year, it is a return on 212,000 dollars, not on 200,000 dollars. How these matters would be treated if made an issue in an appropriate case on appeal cannot be predicted. Perhaps the real meaning of the Neilson decision is that allocation is a hopelessly complex subject where precision of computation must give way to the desirability of a simple formula.

One possible method for avoiding the problem of uncertainty in allocation between community and separate property in such a husband-run family business is present on the facts of the Smith case. The argument for allocating some part of appreciation of the business to community usually involves the principle that the husband is leaving part of the appreciation attributable to his services in a business which he actually owns. It is difficult to imagine a case in which appreciation of value of a business owned by someone other than the husband for which he acted as chief executive could be attributed to the community property of husband and wife on a theory that the husband actually had gained an interest in that business enforceable against the owners by leaving earnings in the business. On the facts assumed
above, it could be argued that if upon incorporation of the Smith business all of the common stock of the enterprise was allocated to Richard and John, with Smith retaining control if desired through ownership of voting preferred stock, no part of appreciation in the common stock (even if it could be shown to be attributable to Smith's services) should be allocated to community property. There are no cases which would tend to prove or disprove this theory, but it does have a certain logical appeal. Its weakness lies in the fact that Smith and his sons are not dealing at arm's length and that Mary might subsequently contend that to the extent any allocation of appreciation to community property would otherwise have been made, Smith has been making periodic gifts to John and Richard.

By a careful tailoring of interests in a corporation, some deterrents to a claim by a wife of a community interest in an originally separate property husband-run business are available. If there is any chance of marital dispute between Smith and Mary, this factor would tend to favor use of the corporate form. The convenience for other purposes of allocating only a nominal value to the common stock in the enterprise increases the significance of the suggested argument here.

Considerations on Formation of a Corporation

The Corporate Form as a Shelter from Personal Liability

One of the least valid reasons for choosing the corporate form is to avoid personal liability. In the first place, since the Smith entity would under some of the organizational plans recommended not include all assets of the present proprietorship (the real property being omitted) it is doubtful whether any lending institution would loan money to the corporation without the co-signature of Smith on the note. Another practical consideration that militates against the supposed advantage of sole corporate responsibility for debts is the personal and emotional response of a man like Smith whose productive years have been identified with the birth and growth of Smith Electric Company. He is usually unable to view its financial difficulties objectively and will usually pledge his personal credit when the business is in difficulties.

There is a further element of risk that weakens the protection afforded by the corporate entity. Men in Smith's position frequently

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9 See text accompanying note 121 infra.
fail to notify suppliers and creditors of the new corporate form and fail to secure from them an agreement to look solely to the corporation to satisfy claims. To Smith it is his business regardless of form. He places orders to be filled after incorporation and fails to obtain express corporate ratification. He fails to notify suppliers that henceforth they will be dealing with a corporation, for he senses than any indication that he is no longer personally liable casts doubts on the solvency, continuity, and standing of the enterprise. Thus, the first thing that Smith is apt to do is incur promoter's liability or mislead creditors so that the law would permit them to disregard the corporate entity.

On the subject of promoter's liability, the case of Shell Oil Co. v. Hanchett is a warning of what can happen to Smith. There, defendant Hanchett entered into a contract to purchase gasoline from Shell Oil Company for the benefit of a taxi corporation he was about to form. Delivery of gas was first made to Hanchett, and he was billed, but after formation of the corporation, it was billed. The corporation became bankrupt. Suit was brought by Shell Oil against Hanchett and he was held personally liable. The court said.

The rule seems to be well settled that a promoter, though he may assume to act on behalf of a projected corporation and not for himself, cannot be treated as an agent of the corporation, for it is not yet in existence; and he would be personally liable on his contract unless there was an agreement to look to the new company, when formed, for payment. 11

Aside from the immediate risks of promoter's liability which will normally decrease and ultimately disappear as contracts made before incorporation are performed by the corporation, what degree of protection does the corporate entity afford in the future? What is the state of the law as to "alter ego," "disregard of the corporate entity" or "piercing the corporate veil"?

It is interesting to re-examine the doctrine set forth forty years ago in the leading case of Minifie v. Rowley to see how far the disregard has extended. Then it was said.

Before the acts and obligations of a corporation can be legally recognized as those of a particular person, and vice versa, the following combination of circumstances must be made to appear: First, that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that

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11 Id. at 243, 63 P.2d at 339.
12 187 Cal. 481, 202 Pac. 673 (1921).
the individuality, or separateness, of the said person and corpora-
tion has ceased; second, that the facts are such that an adherence to
the fiction of the separate existence of the corporation would, under
the particular circumstances, sanction a fraud or promote injustice.13

The first requirement of Minifie v. Rouley has been weakened by
later cases, and the second element allows the trial court to apply a
wide range of discretion in determining whether injustice will be done
if the corporate entity is respected. "The conditions under which the
corporate entity may be disregarded . . . necessarily vary according to
the circumstances in each case . . . within the province of the trial
court."14 One share of stock alone now satisfies the "unity of interest
and ownership" concept that was thought essential in Minifie.15

Besides ownership of shares, other factors considered under the
"unity" concept include commingling of personal and corporate funds,
treatment of assets by an individual as his own, holding out by a per-
son that he is liable for corporate debts, failure to maintain minutes
or records, confusion of records of the individual and corporation,
identical ownership of two or more entities, use of the same office or
files, use of the corporation as a conduit for a single venture, dis-
regard of arm's length relationships, use of the corporation to procure
labor for another entity, diversion of assets from corporation to stock-
holder, use of the corporate form to transfer to it the liabilities of
another entity, and undercapitalization of the corporation.16 Many of
these causes for disregarding the corporate entity are the kind of mis-
takes that Smith will be prone to make, by continuing pre-corpora-
tion practices.

The adoption of the concept of "undercapitalization" as a ground
for disregard of the corporate entity is confusing analytically and leaves
the business lawyer unable to predict the outcome of an attack on the
corporate citadel when thin incorporations of small family ventures are
involved. Writers have been understandably puzzled in attempts to
fit the undercapitalization concept into the alter ego doctrine. One
suggests that "undercapitalization" is in reality a "corollary principle"
to the ordinary alter ego rules.17

13 Id. at 487, 202 Pac. at 676. (Emphasis added.)
held personally liable on corporate note).
16 Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 838-40,
17 Schifferman, The Alter Ego Doctrine in California, in ADVISING CALIFORNIA
BUSINESS ENTERPRISE 785, 796 (California Practice Handbook No. 9, Continuing Edu-
How can a businessman know in advance what capitalization will be regarded as adequate by a court viewing the matter in retrospect after some unexpected financial disaster has occurred? As was pointed out in a dissenting opinion in Automotriz Del Golfo De California S.A. de C.V. v. Resnick, 16

In fact it may be said that every corporation which fails because it is unable to pay its obligations is underfinanced, but certainly that should not be a test of whether the entity should be disregarded. In a rapidly changing economy what might seem to be adequate financing today would be inadequate tomorrow, and it should be obvious that risky business ventures could not be undertaken by use of the corporate device without subjecting the participants to personal liability.19

In Automotriz the majority held that where the monthly volume of business of an auto sales corporation ran between 100,000 and 150,000 dollars, evidence of no capital paid in, or at most 5,000 dollars capital, was sufficient to support a finding that the business was undercapitalized. As a result, the plaintiff, a seller of autos to the defendant, was able to recover from the individuals who organized and loaned money to the company.

The extension of the undercapitalization principle to new fields is well illustrated by Minton v. Cavaney,20 where the estate of an attorney who had acted as an accommodation incorporator with one share of stock was held liable for a tort judgment against the bankrupt corporation. There a corporation was organized to operate a swimming pool. The corporation had no assets except a lease on the pool premises which was later cancelled for failure to pay rent. Plaintiff's daughter drowned in the pool, a wrongful death action was brought against the corporation, and judgment was obtained. When the judgment was not satisfied, an action was brought against the accommodation incorporator-stockholder, and upon his death his personal representative was substituted as defendant. Judgment for plaintiff was reversed on a question of proof, but the concept of individual liability was approved.

Minton is apparently the first case in California to extend the undercapitalization doctrine to tort cases.21 The principle of disregarding the corporate entity has come a long way from the original concept of

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19 Id. at 800, 306 P.2d at 6 (dissenting opinion).
21 Compare Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962), which is also a tort case but which is much more closely related to the traditional reasons for disregarding the entity.
preventing the use of a corporation to perpetrate a fraud on creditors.

The doctrine of *Minton* may well be applicable to the Smith situation. He will probably lease the very valuable real property to the business, and if the acquisition of new equipment is to be financed, the value of the business other than inventory will be offset by debts. Under the expanding concept of implied warranty, the malfunctioning of an electric control in a space package could involve the company in liability running into many millions, or a tort claim for injury or death of operators. Who can say how much capitalization will insulate Smith from personal liability in the face of the *Minton* decision? The corporate form could be a trap leading to ruin if he were to place any reliance on the shelter of the corporation. As a partner in a partnership, he is at least aware of the extent of his personal risk and therefore on notice to obtain adequate insurance. While it is true that insurance companies will often add the owners of a closely held corporation as named insureds without extra premium, this is by custom limited to those holding more than twenty per cent of the stock. Thus John and Richard might not enjoy personal insurance protection during the early years, and conversely Smith might not have a sufficient interest in the corporation to qualify after he has transferred most of his interests to his children as he approaches retirement. Neither would be a desirable result.

In choosing the business form, Smith must consider prospects of business failure as well as success, because the business is small and the new process to be contributed by John is untested.\(^2\) The problems of organization are complicated by the fact that family members with a diversity of investment motives will have interests in the business. Interests will be allocated to members who will participate in management as well as to those who will not. Smith desires to provide interests for his daughter which will carry some senior claim to earnings and liquidation proceeds. He intends salaries to be paid to his sons, and he intends to provide them ownership interests, the value of which will depend on the future success of the business. He feels that his sons should benefit primarily from future earnings of the business, and that he and his wife, and to a lesser extent his daughter, should have the benefits of the present value of the business.

Richard has nothing to contribute to the business other than his services. Karen's husband has a modest income and no prospects of significant earnings improvement. Smith himself wants to protect a

\(^2\) In certain aspects of organization, estate planning considerations cannot be ignored, but we are not attempting to do any more than indicate their general relationship to the choice of form.
substantial part of the capital which he has built up in the business from the risks of the new business. Smith desires to retain control of the new business entity, at least during the remainder of his active years with Smith Electric Company.

The Undesirability of a Single Class of Common Stock

At the outset it should be made clear to Smith that he cannot accomplish the allocation of managerial and ownership interests which he has in mind using only a single class of stock. Smith, Mary, and Karen cannot receive a senior claim on earnings through common stock. Smith can be assured of a preferred claim on the earnings and other resources of the business through his salary, but no similar preferred claim can be made available to Mary or Karen if there is only one class of stock. John and Richard, like Smith, will have a senior claim on earnings and resources of the enterprise by reason of their claimed right to salary as consideration for their services. Assuming that Smith, Richard, and John would be drawing a salary, the use of common stock would offer an anomalous allocation of participating interests in the business. Karen and, after Smith’s death, Mary, the family members who most need a relatively secure income, would have the least assurance of receiving any steady income. Richard and John, who should be most willing to sacrifice the security of steady income in favor of future capital appreciation, would have the greatest assurance of a steady income.

Other disadvantages would flow from the use of a single class of common stock upon incorporation of the Smith business, an enterprise in which some members have no contribution at the time of incorporation other than their promise to provide future services. Stock may be issued as paid-up only in consideration for past services or for property in California and most other states. Richard, who can

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23 This is particularly true if it be assumed that gifts cannot or will not be made among the organizers of the business. It has been assumed for the purposes of this article that Smith, although willing to make a substantial gift to Karen upon incorporation, would not desire to make a similar gift to John or Richard.

24 "No shares of stock, with or without par value, shall be issued except in consideration for any or all of the following:

(c) Services actually rendered.

"If authorized in its articles or by-laws, a corporation may issue the whole or any part of its shares . . . prior to full payment under such restrictions as are imposed by this division." CAL. CORP. CODE § 1109.

25 See, e.g., DEL. CODE ANN. tit. 8, § 152 (1953); N.Y. STOCK CORP. LAW § 69; May, 1965] FAMILY OWNED BUSINESS
contribute nothing but a promise of future services, will be able to acquire paid-up stock of significant value only through gift, loan, or prepayment for his services. It would seem clear, on the other hand, that John may properly receive stock in exchange for his patent, as "intangible property." To the extent that stock was issued to John as consideration for "know-how" associated with the patent or for a promise to help develop the patent, the prohibition against issuance of paid-up stock for consideration other than property might apply.

The prohibition against issuing stock for a promise of future services could be avoided by issuing stock to Richard either in the form of partly paid shares with payment provided by future services or at a price cheaper than that paid by other participants in the business. The latter alternative would result in a gift or a payment for future services, however, and the former would not provide Richard a position of real equality with holders of paid-up stock. It will often not be desirable or feasible for any of the other participants in a business to make a loan or gift to the contributor of services. In many cases, too, it will be impractical for the company or any of the participants therein to pre-pay the contributor of services for his future work. Any attempt to provide shares to the services man at a price cheaper than that paid by other stockholders not only would result in a gift, but also would probably cause Richard to be taxed on the bargain increment as compensation income. Issuance of shares to Richard as partly paid, moreover, would present problems of potential liability to creditors in the extent of business failure. If the initial require-


26 See CAL. CORP. CODE § 1109(e).
27 Compare Rev. Rul. 64-56, 1964-1 CUM. BULL. 133, in which "know how" is defined and under prescribed limits treated as "property" for tax purposes.
28 "[I]t is possible to apply for a permit to issue stock to an employee although only partly paid for by cash and/or service already rendered, with a balance due in services to be rendered." 1 BALLENTINE & STERLING, CALIFORNIA CORPORATION LAWS § 101, at 214 (4th ed. 1964) (quoting Donald A. Pearce, co-author of the edition).
30 CAL. CORP. CODE § 1300 provides that all shareholders are liable to the corporation for the "full consideration agreed to be paid for the shares." If a stockholder promises to provide consideration in the form of services, it would probably be held that upon insolvency of the corporation he is liable to creditors for the cash value
ments of the corporation for tangible property are fixed, the executory obligation of Richard for payment of the remaining obligations on the partly paid shares may increase the aggregate risk of the Smith family.31

One method to at least postpone the recognition of income upon issuance of stock to Richard at a bargain price would be to subject his stock to restrictions on transferability which would have a "significant effect on value,"32 and which would prevent his interest in the shares from having a readily ascertainable fair market value.33 The use of such restrictions would not, however, ameliorate the other problems. To the extent that shares are issued in consideration for services, the availability of section 1244 will be lost, and if stock (presumably that issued for services) is subject to restrictions which make it a "separate class" the availability of subchapter S will be lost.34

Various other schemes can be employed to enable Richard to purchase stock, which for the most part raise their own problems similar to those recited above. For instance, Richard could provide his promissory note to the corporation for shares upon incorporation, a bonus could be provided Richard shortly after incorporation, and Richard could use the bonus to purchase his shares. This scheme would cause Richard to be taxed immediately on the bonus, and the drain on the corporation's liquid assets represented by the bonus might be undesirable.

Even if the problem of the corporation law prohibition against issuance of stock for promise of services and the danger of compensation-income could be overcome, other serious problems would arise if stock was actually provided to Richard or John for a promise of future services. If Richard received more than twenty per cent of the

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31 It is also clear that the bar of cal. Corp. Code § 1109, and similar statutes, cannot be avoided by use of no-par stock. See generally Herwitz, supra note 25, at 1106-07.


voting stock of the new corporation solely for services, rather than for "property," the incorporation-transfer of the old business to the new corporation would be disqualified for section 351 treatment and taxable gain or loss would be required to be recognized upon the transfer and incorporation. This result would follow because the nonrecognition provisions of section 351 apply only in the event that transferors of property are in eighty per cent control of the corporation immediately after the transfer, and because absent qualification under section 351 recognition is required under section 1002.

Stock issued for John's patent would be considered given for property. Also, John could receive stock in exchange for secret processes associated with the patent and for services which are merely ancillary and subsidiary to the "property" transferred. If the services provided are more than ancillary or subsidiary to the patent or process, or if the services relate peculiarly to Smith's business, then they will not be considered as "property."

Additional problems could flow from the issuance of stock for services, or from the issuance of stock to the contributors of services at a bargain price. One of the advantages of use of common stock in a small business is the possible qualification of that stock for section 1244 treatment. Internal Revenue Code section 1244 enables the original holders of stock qualifying under that section to enjoy ordinary losses in the event of a sale at a loss, or worthlessness, of his shares, and to enjoy capital gain treatment on sale of shares at a profit. These provisions make the use of common stock very desirable in planning with the possibility of business failure in mind if qualification for Section 1244 treatment can be assured.

Certainly the organizers of any small business should insure that any common stock created upon incorporation does qualify under section 1244; qualification under that section is easily achieved in most cases. It will be assumed that common stock used in the business will be qualified to the extent possible.

Section 1244 treatment will be lost, however, to the extent that shares are issued for "services" rather than "property." A prerequisite for qualification is that the stock be issued for property other than stock.

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or securities.\textsuperscript{39} Although the regulations do not make this clear, it would appear that stock issued to a contributor of services at a bargain price would be considered to be issued in part for services and therefore disqualified for section 1244 treatment.\textsuperscript{40} Also, the requirement of the regulations that the stock be issued "pursuant to a... plan... to offer only such stock during a period... [of no more] than two years,"\textsuperscript{41} could be construed to disqualify all of the stock if any shares in the initial offering were issued for services. Until these questions can be answered with certainty, it would be inadvisable for a small business to risk loss of section 1244 benefits by issuing any common stock directly for services or at a bargain to the contributor of services.

Even if it be assumed that the common stock of the Smith business would qualify for section 1244 treatment, the use of a single class of common stock upon incorporation of the business would still not be feasible or desirable, though such a plan would maximize the availability of ordinary loss deductions to the organizers. The serious problems in allocating ownership interests among people with diverse investment motives, and the dangers of compensation income to the contributors of services should be of prime deterrent importance in organizing the Smith business.

\textit{The Case for Use of Common Stock and Debt}

One straightforward but dangerous method for allocation of the ownership interests in the proposed corporation to avoid the problems of a single class of common stock would be to create solely debt and common stock. Under the hypothetical facts Smith, Mary after Smith's death, and Karen are to receive a senior claim on earnings and liquidation proceeds in the new business. Richard and John are to receive solely interests which will enjoy appreciation in the event of business success, but not carry any senior claim to earnings or liquidation proceeds. Smith is to retain control of the business.

It would appear that all of these investment motives could be satisfied by allocating to Smith, Mary, and Karen senior debt securities approximately equal in value, or face value, to the value of the old business, and by allocating all of the common stock, which would have nominal value equal at least to the ascertainable value of John's new

\textsuperscript{39} \textit{Int. Rev. Code of 1954, }\S\ textit{1244(c)(1)(D).}

\textsuperscript{40} Cf. George S. Carter, 36 T.C. 128 (1961).

process, to Smith, Richard, and John. Smith could then retain a bare majority of common stock, and Richard and John could share the bare minority of common stock. In this manner Richard and John could have an interest in the business which would derive value from future earnings, as well as enjoy a senior claim on the earnings of the business through their right to salaries; Smith could retain control; and Karen, Mary, and Smith could enjoy the desired senior claim on earnings and liquidation proceeds provided by their ownership of the corporation’s debt.

An arrangement of ownership interests which employs substantial debt and gives the common stock only nominal value would avoid substantially all of the problems which flow from the use of common stock alone. The peculiar advantage of creating common stock of only nominal value is that any family member can easily be enabled to pay full value for the business interest which will directly reflect appreciation in the value of the business. Although it would be difficult for any participant to make a substantial loan or gift to Richard or John, if the purchase price which they will have to pay is nominal, a small loan or gift could be easily arranged. The prohibition against issuance of stock for a promise of future services is no longer a problem if the contributor of services can be provided funds for purchase of his shares. Similarly, if each stockholder can be easily enabled to pay full value in property for his stock, the danger that the incorporation-transfer would fail of qualification under section 351 will be eliminated. The disadvantage of the absence of senior securities in the one-class-of-stock plan is cured by the availability of debt to be allocated to those persons who desire a preferred claim on earnings or liquidation proceeds.

The advantages of qualification of common stock for section 1244 treatment will be lost under this plan to the extent that the original basis of the common stock is reduced. The ordinary loss treatment available to the original stockholder for losses on section 1244 stock is distinctly more beneficial than the capital loss treatment available in the case of losses on non-business bad debts.4 It would be certain under our facts, moreover, that none of the debt proposed to be created upon incorporation of the Smith business would be treated as business debts.43 The advantage of using substantial common stock,

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42 Upon becoming worthless, business bad debts yield ordinary loss deductions, whereas non-business bad debts bring short term capital losses. Int. Rev. Code of 1954, § 166. Normally, a debt will bring capital loss treatment, long term or short, depending on holding period if sold at a loss since the obligation will constitute a capital asset under Int. Rev. Code of 1954, § 1221.

and thereby maximizing the availability of section 1244 treatment in the event of business failure, is outweighed by the advantage of replacing common stock with debt because of the attendant disadvantages of using substantial common stock and the significant tax advantages which would result from the use of debt in the event of business success.

Upon the receipt of substantial earnings, and the attendant buildup of earnings and profits, the ownership of debt of the corporation would enable the creditors to withdraw property\textsuperscript{44} from the corporation as repayment of principal without danger of dividend treatment.\textsuperscript{45} If the creditors were also stockholders, a balancing of individual and corporate taxable incomes could be achieved through choice and timing of dividend payments and repayments of debt. The payment of interest on debts is taxable to the creditor,\textsuperscript{46} but unlike dividend payments, interest payments are deductible by the corporation\textsuperscript{47} and reduce earnings and profits.\textsuperscript{48}

In short, the tax advantages of a substantial amount of stockholder debt, or debt in the hands of non-stockholders such as Karen and Mary, would be extremely significant and would probably provide more potential for tax savings than use of a maximum amount of common stock qualifying under section 1244.

Unfortunately for Smith, the Internal Revenue Service is fully cognizant of the potential loss of revenue which is presented by the use of debt in a small, closely held corporation. A plan so crude from a tax standpoint as that proposed would introduce so many areas of troublesome uncertainty for the Smith family that significant departure from the proposed allocation of stock and debt would be necessary.

\textbf{Difficulties in Use of Substantial Debt}

\textbf{Uncertainty upon Incorporation}

One of Smith's primary tax motives upon incorporation should be nonrecognition of tax at the time of incorporation. The use of common stock alone was considered undesirable because it prejudiced qualification under section 351. For different reasons an equally serious

\textsuperscript{44} If appreciated property is used to satisfy such an obligation, a capital gain would result.


\textsuperscript{48} See Bitter, \textit{op. cit. supra} note 45, § 5.05, at 148.
threat to nonrecognition of gain in the incorporation is posed by use of substantial debt.

If the transfer of the old business to the new corporation meets the requirements for qualification under section 351, the transaction will ordinarily be tax free to the extent that “stock or securities” in the new corporation are created in the hands of the transferors. The transaction will still qualify under section 351 if property other than stock or securities is given to the transferors, but a taxable gain would be recognized to the extent of the value of such “other property.”

In the Smith business, recognition of gain upon incorporation would probably entail the recognition of substantial ordinary income. To the extent that the transaction was taxable, and the property of the old business was therefore considered sold to the corporation, the transferors would realize ordinary income by reason of depreciation recapture to the extent that depreciation for tax purposes on the personal property in the business since December 31, 1961, is reflected in taxable gain. There would also be a tax at ordinary income rates imposed by reason of depreciation recapture on the real property in the business to the extent that depreciation taken on a faster than straight line basis after December 31, 1963, is reflected in taxable gain. Inventory of the Smith business, to the extent a taxable exchange was determined, would likewise result in ordinary income. In addition, to the extent that non-capital assets of Smith’s sole proprietorship had a value in excess of their basis at the time of the incorporation, a recognition of gain on incorporation would result in a tax at ordinary income rates if Smith, or Smith and Mary, received more than eighty per cent in value of the stock of the new corporation.

Some commentators have raised the question whether, upon a taxable incorporation, the principals could allocate the basis of contributed assets by agreement. In other words, it would usually be advantageous to allocate “other property” as having been exchanged for

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49 See id. §§ 3.12-.13. If the reserve method of accounting for bad debt had been employed by Smith in his individual business, a taxable gain would be recognized by Smith to the extent of the balance in the reserve account at the time of incorporation. Estate of Heinz Schmidt, 42 CCH Tax Ct. Rep. Dec. 26987 (1964).

50 See generally Britker, op. cit. supra note 45, §§ 3.01-.14.

51 INT. REV. CODE OF 1954, § 351(b).

52 INT. REV. CODE OF 1954, § 1245.

53 INT. REV. CODE OF 1954, § 1250.

54 Grace Bros., Inc., 10 T.C. 158 (1948), aff’d, 173 F.2d 170 (9th Cir. 1949).

55 INT. REV. CODE OF 1954, § 1239. If the purported debt of the enterprise is treated as stock for tax purposes then Smith would probably own more than 80% in value of the new corporation’s stock.
depreciable property not subject to depreciation recapture, and allocate “stock and securities” as having been exchanged for inventory, property subject to depreciation recapture, and other property the sale of which would give rise to ordinary income. It would appear that any challenged attempt to make such an allocation would be unsuccessful, and that recognition would be required in proportion to the fair market value of the transferred assets.56

If the definition of “stock and securities” cannot be applied with confidence to the debt and stock created upon incorporation of the Smith business, Smith and his family will incur dangerous risk. The risk will include not only assertion of a tax but also a tax at ordinary income rates to the extent nonrecognition property is treated as having been exchanged for depreciable assets or inventory.

The rules for determining what is a “security” within the meaning of section 351, however, are by no means clear. The classification of “stock” for purposes of section 351 would appear to be easy enough by reference to basic corporate principles, but neither the code nor the regulations provide any meaningful standard for distinguishing between debt “securities” and “other property.” The available authority indicates that “the length of time to maturity is regarded as the most important single earmark.”57 The longer the maturity of debt created on incorporation, the more likely the instrument is to be considered a “security.” Any debt instrument providing for maturity sooner than five years from the date of issuance would ordinarily be treated as “other property.”58 Under what circumstances will instruments with maturity longer than five years be considered as “securities”? The answer is not clear, but any provision in the instrument which indicates a more permanent participation of the creditor in the business, such as provision for participation in management upon default, would probably strengthen the argument for “security” classification.59 If the length of the maturity date is expanded, particularly if it is increased to more than ten years, and if any additional provisions indicate an intention on the part of the creditor to maintain his relationship for a significant length of time, “security” status can be as-

58 Britten, op. cit. supra note 45, § 3.03.
sured. Unfortunately, there are equally compelling tax dangers which would be exacerbated by the extension of maturity date of the "debt" or by any provision that a purported creditor could share in management in the event of default. Any such provisions would potentially damage defense of the purported debt against Service attack on its status.

If only "securities" are given to Karen, and if such securities carry no voting rights, then it is arguable that Karen does not qualify as a "transferor" entitled to nonrecognition treatment under section 351. This problem could be solved with relative ease by creating nominal stock in Karen's hands, or by arranging for Smith to incorporate his business before giving any interest to Karen.

No plan for incorporation should be arranged for Smith unless it can be predicted that no tax will arise from the incorporation transfer. The compelling importance of predictability at this stage cannot be overemphasized. If Smith and his family recognize a substantial tax liability upon incorporation of their business, the funds used to satisfy the tax obligation would probably be, in effect, withdrawn from the working capital of the new business.

Uncertainty After Incorporation

Another area of potential uncertainty in connection with allocation of debt and common stock would result from the vulnerability of the purported debt to a Service attack of its status as debt for tax purposes. The points which the Commissioner would raise would be the availability of interest deductions to the corporation, the availability of bad debt deductions to the stockholder, and the proper recognition of payments made with respect to the purported debt. If predictable results are not available in the event of Service attack on any of these points, then most of the advantages claimed for the creation of debt upon incorporation of the Smith business will be lost.

61 See generally Britten, op. cit. supra note 45, § 3.03, at 82.

62 Section 351, read literally, appears to require that each of the "transferors" who is to qualify for nonrecognition treatment must actually share in the ability to exercise control by receipt of a security entitling him to vote. If this be true, any person who does not receive a voting security would have to treat the transfer of property in exchange for his nonvoting interest as a taxable exchange under § 1002. Section 351 could reasonably be construed, however, to intend that the recipient of nonvoting securities should be entitled to nonrecognition if he was associated with the persons obtaining control in the transaction. Cf. Burr Oaks Corp., 43 CCH Tax Ct. Rep. Dec. 27340 (1965), in which the Tax Court holds that a recipient of a nonvoting interest may be considered a transferor for the purposes of the control test of § 351.

Perhaps no tax question of corporation-stockholder relations has been as litigated as the question of the bona fides of stockholder debt. A general discussion is beyond the scope of this article,64 but the tax status of stockholder debt created upon incorporation of a small going business is of concern here. The recent leading cases on this narrow point reflect a tendency of the courts to emphasize subjective rather than objective factors, and reveal several arguments of the Commissioner which have a significant impact on this kind of stockholder debt. In the recent cases the Service has argued that a showing that the purported debt was created in consideration for a substantial part of the operating assets of the business should carry the court a long way65 toward a finding that the debt was intended to be "permanent investment in the risk of the business rather than ... [a] temporary loan."66

The Commissioner can usually muster other factors which will provide inferential support for his argument that the purported creditor must have, or must be presumed to have, intended to contribute the purported debt as part of the permanent capital structure of the business. Such factors may be: (a) the actual experience of the creditor in failing to observe formalities or in extending the due date of installments without formal negotiations;67 (b) the lack of investment quality of the purported debt—usually sought to be established in part by the basis of ratio of debt to equity,68 as well as by a consideration of the possibility of obtaining outside credit on similar terms;69 (c) pro rata holding of stock and debt, which appears particularly significant when post-incorporation advances of purported debt are maintained in studied proportion to stock holdings.70

The Commissioner may be expected to argue, in the absence of other factors providing significant support for an attack on the purported debt, that in a going business new debt cannot be created

64See generally Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1 (1960); Caplin, supra note 63.
65The exact evidentiary relationship between the questions of pure fact and the ultimate findings is not clear.
66Brake & Elec. Sales Corp. v. United States, 287 F.2d 426 n.1 (1st Cir. 1961) (quoting the district court).
67Ibid., cf. Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956).
68The ratio of debt to equity is seldom cited in the more recent cases as a factor of independent significance, and has been disregarded in some cases. See Rowan v. United States, 219 F.2d 51 (5th Cir. 1955).
69See Benjamin D. Gilbert, 17 CCH Tax Ct. Mem. 29 (1958), aff'd, 262 F.2d 512 (2d Cir. 1959). See generally Goldstein, supra note 64.
70Charter Wire, Inc. v. United States, 309 F.2d 878 (7th Cir. 1962); Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959).
either by a dividend on equity\textsuperscript{71} (in the case of a corporation) or by incorporation\textsuperscript{72} (in the case of an unincorporated business) without the injection of new capital; in other words the operating assets the purchase of which was originally financed by an equity investment cannot be refinanced internally so as to provide the basis for stockholder debt.\textsuperscript{73} A position which would disallow the creation of stockholder debt in exchange for (or to finance the purchase of) operating assets would, in effect, preclude creation of debt upon incorporation of the typical small business. In fact, the relationship of the financing of basic assets and the creation of debt has been rejected as a determinative factor in itself, and treated as only one factor in reaching the ultimate question of the intention, or presumed intention, of the "creditor" toward his purported debt interest in the business.\textsuperscript{74}

It is also important to note that the argument that stockholder debt must be of sufficient investment quality to permit outside borrowing would usually be fatal to the creation of debt in small business. This factor has not been accepted as determinative by itself.\textsuperscript{75} The general approach of the circuit courts toward stockholder debt, and particularly debt created upon incorporation of a going business, has been to approve the application of various factors to the determination of the ultimate question of the "real" intention of the parties as to the transaction.\textsuperscript{76} The test of "intention" here is not necessarily subjective.\textsuperscript{77}

The present case law on this question is not conducive to certainty

\textsuperscript{71} Compare the following description of the Commissioner's position as described in Kraft Foods Co. v. Commissioner, 232 F.2d 118, 126 (2d Cir. 1956). "The Commissioner argues that since the debentures were neither issued for borrowed money nor against accumulated earnings, they simply represented the originally-invested equity capital in a new dress. He asserts, in substance, that a closely held corporation and its controlling stockholders are powerless to change any part of initial equity capital into valid indebtedness by means of a dividend valid under state law." This position was rejected in the Kraft Foods case.

\textsuperscript{72} See the court's comment on the government's position in Daytona Marine Supply Co. v. United States, 61-2 U.S. Tax Cas. ¶ 9523, at 81221 (S.D. Fla. 1961). "The Government in this case appears in reality to be contending for a new or novel rule of law to the effect that no bona fide indebtedness for Federal tax purposes can be created where the organizers of a new corporation cause operating assets to be transferred to it as a part of its initial capitalization in return for the issuance of bonds and stock." The court then rejected the government's position.

\textsuperscript{73} Ibid.

\textsuperscript{74} Ibid.

\textsuperscript{75} See Benjamin D. Gilbert, 17 CCH Tax Ct. Mem. 29 (1958), aff'd, 262 F.2d 512 (2d Cir. 1959), where one of several findings listed by the court was that "no outside investor would have made similar advances without security." Id. at 30.

\textsuperscript{76} Benjamin D. Gilbert, supra note 75.

\textsuperscript{77} Ibid.
in planning the debt-stock structure of small corporations. The importance of certainty in creation of stockholder debt is increased by the virtually universal practice of the tax cases to hold either that the purported debt is all debt or all equity. This all or nothing approach is certainly anomalous in the sense that many of the factors applied by the courts involve questions of degree—the ratio of debt to equity, the extent to which basic operating assets have been financed by debt, and the investment quality of the purported debt. In most of the cases in which the Commissioner has been successful in attacking debt instruments which appeared valid on their face, any significant reduction of the amount of debt relative to equity would appear to have provided the taxpayer a better chance of victory. Still, it would be difficult for the Commissioner or a court to draw a precise line defining a quantitative limit on the permissible debt. Such judicial definition would be impractical if not improper, and there have been suggestions that some specific quantitative standards should be provided by statute.

The cases involving stockholder debt are of concern to the Smiths. Under the proposal for creation of debt equal to ninety per cent or more of the value of the old business, Smith and his family had planned to allocate some portion of debt to Karen, who would own no stock in the enterprise, and to allocate common stock to John and Richard, who would own no debt of the enterprise. The debt and stock would not be held proportionately, and not all of the debt would be held by stockholders. Neither the lack of pro rata holding, nor the presence of some non-stockholder debt would significantly increase the strength of the purported debt against Service attack, however. The absence of strict pro rata holding has not been considered a factor favorable to the taxpayer if one managing owner, Smith in our case, holds the lion's share of stock and debt. Also, a lack of pro rata holding resulting from allocation of equity to the

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78 See Goldstein, supra note 64, at 10, 30. But cf. Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959) (differentiating between instruments identical on their face held by family and nonfamily members). No reported cases have been found which allowed some but not all of the debt on a quantitative test.

79 "We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt." Miller's Estate v. Commissioner, 239 F.2d 729, 734 (9th Cir. 1956).


services-man (Richard) and debt to the money-man (Smith), has been considered a neutral factor in determining the bona fides of purported debt.\textsuperscript{2} Moreover, almost every other factor which has been cited by the courts in the stockholder debt cases could be applied to an Internal Revenue Service attack on the purported debt. The Service could argue that substantially all of the operating assets of the old business had been exchanged for debt in the new corporation. It would be obvious, then, that the purported creditors would have to look to future earnings for repayment of their debt. Even in the Ninth Circuit, which has generally rejected the factor of transfer of operating assets for debt as a point of peculiar importance, the preponderance of debt created upon transfer of the operating assets of the Smith proprietorship to a corporation would provide support to the Service attack.\textsuperscript{3} The debt to equity ratio in the Smith corporation, assuming allocation of stock and debt in the manner tentatively proposed above, would be very high. Moreover, it could not be said that substantial equity had been invested in the business, and it would be clear that an outside creditor would not loan to the Smith business on terms similar to the debt held by the Smith family. The investment quality of the debt, then, would be found to be very low. Also, on the basis of authorities available in the Ninth Circuit concerning subordination of stockholder debt to outside creditors on bankruptcy,\textsuperscript{4} it would appear that the Smith family debt would be vulnerable on this ground too. This factor has importance both because Smith and his family would be planning, presumably, for creation of debt which would withstand attack by outside creditors, and because the court in a tax case might consider vulnerability in the property law context to be a significant factor in determining the bona fides of the debt for tax purposes.

Finally, if debt were created approximately equal to the value of the old business upon incorporation, it would be extremely unlikely that installment payments could be made when due during the early years of the new business unless the payments were described under

\textsuperscript{2} "It is true that the advances made by the taxpayer were not proportionate to his stock holdings . . . But here the amounts paid in for capital stock were so small as to be purely nominal and the taxpayer's contribution in cash was balanced by highly skilled services contributed by other stockholders. In such a case, neither reason nor authority requires that for purposes of federal tax law advances by a stockholder shall constitute risk capital only if contributed in proportion to existing stock holdings." Reed v. Commissioner, 242 F.2d 334, 335 (2d Cir. 1957).

\textsuperscript{3} Miller's Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956).

\textsuperscript{4} E.g., Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958).
a schedule which took into account the possibility of reduction of
earnings during years of development and marketing of John’s process.
If extensions were made in the due date of installment debt, it would
be another argument against the purported debt; if the length of
maturity were extended in order to flatten the size of the periodic
payments, the duration of the obligation would strengthen the argu-
ment that the purported debt was intended as part of the permanent
capital structure.

The strength of this attack would be significantly weakened if
formalities customary among corporation creditors were observed in
connection with the extensions. In the Smith family business, however,
it would be unlikely that strict formalities could be observed if several
installments were missed. The incentive present to outside creditors
in preserving their claims would be diminished in the case of Smith
and other members of the family holding the purported debt.

In summation, upon incorporation of a going business such as the
Smith business, the danger of successful attack on stockholder debt
indicates that it would be unadvisable to create debt in the face amount
of the going concern value of the old business and to create common
stock of only nominal value. In fact, such an allocation would seem to
cause problems as great as those presented by the use of common stock
alone.

The Case for Use of Common Stock,
Preferred Stock and Debt

Can a combination of nominal common stock, preferred stock, and
debt be tailored to avoid the dangers of the plans above and still
properly reflect the various interests of the Smith family in the
business?

Two vulnerable aspects of the debt used in the previous example
were its value in relation to the actual value of the common stock and
its lack of class from an investment standpoint. It was also anticipated
that an attack could be made on its status because it was received
in exchange for essential operating assets of the business. The size of
the debt complicated planning for making payments when due, unless
special payment plans providing for reduced installments in the
earlier years could be tailored, and it was anticipated that any exten-
sion of payments without proper formalities could strengthen argu-
ments against the debt.

If a substantial portion of the debt used in the previous proposal
was replaced by preferred stock, not only could the installment pay-
ments more easily be made when due, but the impact of the other Internal Revenue Service arguments would be lessened.

For instance, Smith might replace half of the debt created in the previous proposal with preferred stock. Under the prevailing regulatory climate of the California Division of Corporations, creation of preferred stock in a newly incorporated business would necessitate the imposition of an escrow condition as a prerequisite to the issuance of shares.\(^8\) This condition will not be particularly onerous to the ordinary family business, however, because members of the family will usually resign themselves to relatively poor prospects of sale of their stock to outsiders until the business has achieved a substantial earned surplus. In the event of such substantial surplus, the escrow condition could presumably be removed. As a prerequisite to removal of the escrow condition, the Division of Corporations would require that the preferred stock contract provide the preferred stockholders voting rights in the event of dividend failure.\(^6\) Presumably, these provisions would not be required if only the common stock was released from escrow. If questions regarding future relocation of voting control upon a desired public sale of the stock are to be avoided, it might be desirable for the preferred stockholders to be given majority voting control in the first instance. In our case this would mean awarding a majority of the preferred stock to Smith.

Smith could upon incorporation create debt, preferred stock, and common stock in the following proportions relative to the value of the old business: debt forty-eight per cent, preferred stock forty-eight per cent, and common stock four per cent. Using these proportions, the significant advantages flowing from creation of common stock of only nominal value would be retained. Smith could still retain control of the corporation through ownership of a bare majority of the stock to which voting control was awarded. Assuming two per cent of the total value of the business to be a nominal amount in value, it would be easy for John or Richard, by loan or gift from Smith or otherwise, to obtain sufficient funds to purchase their common stock interests.

The proposed allocation of debt, common stock, and preferred stock would strengthen the position of the purported debt against attack by the Internal Revenue Service, though predicting results in this regard has been complicated, as noted above, by the difficulty of applying the factors used by the circuit courts. The debt to equity ratio would no longer present a factor favorable to the Service, and


the investment quality of the debt would have been increased so that it would be doubtful whether the Service could argue that no outside investor would loan on similar terms. With the size of the debt reduced to less than fifty per cent of the value of the old business, it would probably be possible to tailor the debt so that the periodic installments would be within the corporation's budget, even during the early years of development and marketing of John's process. If the payments were actually made, the argument that the obligations were not treated by the principals as "debt" could be avoided. The argument that debt was given in exchange for basic operating assets and that repayment could be accomplished only out of future earnings would still be available. The Service would no longer be able to argue that the operating assets had been financed entirely by debt, however, and this factor by itself has not been accepted as determinative in recent cases, particularly in the Ninth Circuit.87

Some additional protection for the purported debt in the enterprise could be provided by withholding some basic asset of the corporation and leasing it to the newly formed corporation. To the extent that the value of the assets transferred was reduced by withholding the asset, the debt created could be reduced. The leased asset would be analogous to a senior debt security in the hands of the Smith family, but there is no indication under present authorities that the interest of the lessor could be treated as "equity" for tax purposes.89 Despite the similarity between stockholder debt and the stockholder's interest as lessor in a real economic sense, a plan employing such a leasehold interest would provide more assurance to the Smith family that the debt would be recognized for tax purposes; the debt to equity ratio would be lower and the debt payments would be easier, although the investment quality of the remaining debt would probably not be increased. Under this plan Smith and Mary could retain an interest in the corporation land, which for this purpose one might assume to be equal in value to twenty-five per cent of the total value of the going business, and the remaining seventy-five per cent of business value could be allocated twenty-three per cent to debt, forty-eight per cent to preferred stock and four per cent to common stock.

On planning control under this plan, it would probably be ad-

88 Miller's Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956); cf. Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956). Compare Caplin, supra note 63, at 792-93.
89 See generally Goldstein, supra note 64, at 28-31.
visable to give voting control to the preferred stock and to have Smith retain all of the preferred stock during his lifetime, allocating all of the common stock to Richard and John. In the event of business success, this allocation would diminish the possibilities of increase of Smith’s estate. Smith would still enjoy the benefit of business success to some extent in the form of appreciation of his preferred stock, however. By this plan, also, the problem of negotiating with the Division of Corporations concerning the voting rights to be provided the preferred stockholders on application for release of escrow could be avoided. Smith could provide for Richard and John to enjoy control of the corporation through ownership of more than half of the preferred stock after his death, either by bequest of the preferred stock or by an appropriate buy-sell provision.

The reduction of the relative value of the debt in the corporation would decrease the availability of an “escape hatch” for withdrawal of corporate assets without dividend treatment. Withdrawal of assets by redemption of stock ordinarily involves a dangerous risk of dividend taxation. This is usually true of redemption of preferred stock as well as of common stock. Redemption of preferred stock, when preferred and common stock are not held pro rata, may more easily be established to be substantially disproportionate for the purposes of section 302 of the Internal Revenue Code than redemption of common stock. The reduction of the amount of debt created upon incorporation may not be as serious a tax detriment, then, as it would have been had the proposed debt been replaced by common stock.

On the other hand, to the extent preferred stock has been used in the plan, beneficial tax attributes available with use of common stock or debt have been lost. Preferred stock neither allows tax-free withdrawal of property with certainty of non-dividend treatment upon business success, as does debt, nor provides potential enjoyment of ordinary loss deductions upon business failure, as does common stock which qualifies for section 1244 treatment. Preferred stock has the compensating advantage of acting as a ballast to maintain advantages otherwise to be derived from common stock and debt, while at the same time avoiding the cumbersome aspects of common stock alone and the dangerous vulnerability of substantial debt which reflects a substantial part of the value of the incorporated business.

On balance, the use of preferred stock, debt, and common stock in the manner described, particularly when used with the suggested

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91 Himmel v. Commissioner, 64-2 U.S. Tax Cas. ¶ 9877 (2d Cir. 1964).
lease arrangement of some business real property, appears to provide a reasonable accommodation of the investment and tax planning requirements of the Smith family. If the prospects of business success alone are considered in planning for the Smith family business, the use of the corporate form with this allocation offers a very desirable organizational alternative. In contrast to the old Smith proprietorship, or to any new unincorporated form, the corporation as a separate tax paying entity will enjoy low rates on the first 25,000 dollars of earnings and provide a mechanism for deflecting taxable income from individual stockholders. Because there will be a variety of interests in the corporation, a great deal of flexibility in the distribution of taxable income from the corporation to the principals will be available. Although the debt installments will probably be required to be paid when due, flexibility will be available in paying dividends, and considerable flexibility will be available in setting rent payments and salaries. Through planning the various corporate distributions, a kind of averaging of income for the family participants should be available.

Use of the corporate form is less attractive if the prospects of initial operating losses or of ultimate business failure are considered. In the Smith business the prospect of several years of substantial marketing and development costs in connection with John’s new process may indicate a likelihood of low profits, or even losses, during the early years. During any period of operating losses, running the business as a corporation may be costly. Operating losses of a corporate business cannot be passed through to the stockholders unless an effective election under subchapter S can be made and maintained. In the Smith case the use of a single class of stock, which is a prerequisite to a qualification under subchapter S, is not practical; for that reason alone a subchapter S corporation is often not a feasible alternative in planning the organization of the small family business. It is important to note, too, that an attempt to maintain a “single class of stock” for subchapter S purposes by use of common stock and stockholder debt is extremely dangerous; successful attack on the debt character of the purported debt would cause retroactive disqualification under subchapter S because the “debt” would be treated as a second class of stock. Even if subchapter S status could be elected and maintained, certain dangers would be present. Many small businesses achieving

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92 Int. Rev. Code of 1954, § 11(b), (c).
subchapter S status have suffered from the impact of the subchapter S rule that a stockholder’s proportionate share of operating losses in excess of his basis is not only disqualified for deduction to the stockholder, but also lost for all time as a deduction to the corporation. This is not the rule in the case of a partnership; under partnership rules, losses are limited as deductions to the basis of the partner, but a loss in excess of basis in one year may be carried forward indefinitely into future years. Absent subchapter S status, any losses incurred by the Smith business in corporate form during the early years will be deductible only by the corporation. Even during years of operating loss for the business, Smith and Mary may be in a relatively high tax bracket because of income from rentals paid on the real property and from their non-business investments. Smith’s and Mary’s individual tax brackets may well be higher during these years than the corporation rates during any of the five years following the initial years of operating loss, so that even if the losses may be carried over by the corporation to future years, the disadvantage of loss of these deductions to Smith and Mary may be substantial.

Similarly, the use of common stock which qualifies for section 1244 treatment cannot provide the same direct pass-through of operating losses which is available in a partnership. To the extent that common stock qualifies for section 1244 treatment ordinary loss deductions would result to the original stockholders upon sale of their stock at a loss, but initial losses by an ultimately successful business would not be available for pass-through to the stockholders unless the stock was sold by the original stockholders while a loss could still be recognized. Such a sale would be unlikely in the case of a family business, and even if such a sale did occur, an undesirable bunching of deductions would result unless there were periodic sales. On the planned allocation of common stock in the Smith business, moreover, the loss available for section 1244 purposes would be minimal because of the low original basis of the common stock.

If it be assumed that the first years of operation of the Smith business, years of substantial development and marketing costs, will be unprofitable, then it will usually be desirable from a tax standpoint to maintain a partnership rather than a corporation form for that period.

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Considerations on Formation of a Partnership

Except for gift taxes to the extent that Smith gives interests in the business to his children, the contribution of assets to the partnership will not be a taxable event.\(^{100}\) John can contribute his patent at its fair value without tax consequence. The parties have a reasonable latitude in determining fair value unless it is clearly unrealistic. The regulations provide that “normally, under local law, each partner is to be repaid his contribution of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) . . . .”\(^{101}\) The basis to the partnership, as distinguished from the capital accounts of the partners, will be the adjusted basis of the property to the member contributing it, determined at the date of contribution.\(^{102}\) Smith can also lease the real property to the partnership at fair rental value. A partner engaging in a transaction with a partnership (except for certain sales and exchanges in the case of a “controlled partnership,” which the Smith Electric Company would be) can deal as if he were not a member of it.\(^{103}\) Smith's lease of the real property to the partnership will have one undesirable effect in that a donor’s “retention of control of assets essential to the business”\(^{104}\) is one of the elements considered in determining whether a donee is in reality the owner of a capital share. Smith Electric Company will be a working partnership to which John is contributing a valuable patent, so the retention of the real property should not have adverse effect, though it is less desirable than a lease to the corporate form. Smith's loans to the partnership do not run afoul of the uncertainties that would be created in the corporate form.

Daughter Karen’s interest can be established as that of a limited partner; her share of profits should be in direct proportion to her share of capital after allowance for managerial services because of the family partnership rules, and her interest should also be qualified under the provisions of Treasury Regulations section 1.704-1(e)(2)(ix). Thus does not conflict with Smith's general planning, since if Karen's distributive share of profits is small during the early years there will be no drain on partnership funds, and if the business becomes profitable, even a small interest will provide her with substantial income. As a limited partner she incurs no personal liability in the event of failure.

\(^{100}\) Int. Rev. Code of 1954, § 721.
\(^{103}\) Int. Rev. Code of 1954, § 707.
of the venture and does not participate in the management; there is thus no threat of disruptive interference by an absentee owner unfamiliar with the business.

The difficulties in allocation of income between Smith and his sons under tax rules affecting family partnerships are perhaps the principal problems encountered in the partnership form. Partnerships between strangers have virtually unlimited power to allocate distributive shares of income without regard to the extent of capital contributions, and wide latitude is afforded such partners to adjust their shares from time to time by partnership agreement.

In the case of the family partnership, subsection (e)(2) of Internal Revenue Code section 704 states that reasonable compensation must be allowed for services of the donor and that the return on donated capital must not be proportionately greater than the share of the donor with respect to the donor's capital. Moreover, subsection (e)(1) requires that the transferee must be the real owner—he must have "dominion and control" over the interest he has acquired.\textsuperscript{105} If any substantial gifts of partnership interests are to be made to the children, the tests set forth in the regulations as to the tax reality of "dominion and control" of the children will limit the drafting of the partnership agreement, including its buy-sell provisions. In this area, reference has already been made to the fact that retention of control of the real property is one of the elements the Internal Revenue Service can consider in determining whether Smith should be treated as remaining the substantial owner of the business. The draftsman of the partnership agreement would therefore be particularly careful to avoid restrictions on the rights of the children to dispose of their interests at fair market value, powers in Smith to decide what shall be retained in the business, or any other powers in him inconsistent with the normal management participation of the sons, taking into consideration their business functions and capital shares. To this extent, the corporate stock buy-sell has greater latitude and, except as restricted by the law governing duties of majority stockholders to minority interests, the corporate form has more flexibility in this area.

Since Smith does not wish to make unnecessary taxable gifts at the present time, since John is contributing a valuable asset (the patent), and since the business will need funds for expansion, Smith could loan money to Richard in an amount equal to the fair value of John's contribution, taking Richard's note on terms that would apply to an arm's length transaction. Since Richard's experience and selling,

\textsuperscript{105} Treas. Reg. § 1.704-1(e)(1)(iii) (1956).
ability is vital to the business, the transaction is reasonably related to the success of the partnership and should qualify to meet the tests of "reality of purchased interests" under Treasury Regulations section 1.704-1(e)(4)(ii) and thus help to take the case out of the restrictions applying to gifts of partnership interests.

The test of the bona fides and business reality of the partnership rather than form or extent or source of contribution to it was laid down prior to the 1954 Internal Revenue Code by the leading case of Commissioner v. Culbertson, wherein it was said.

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case [Commissioner v. Tower, 327 U.S. 280 (1946)], but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

An interesting provision of partnership tax law introduced by the 1954 Internal Revenue Code that may have relevancy to the Smith partnership is the provision of section 707(c) allowing guaranteed payments to a partner for services. Since John and Richard need a minimum income for living expenses and presumably have no outside resources, it would be appropriate to provide salaries for them in some reasonable amount. This also has the effect of reducing Smith's taxable income and in loss years would benefit the family member in the highest personal bracket. To the extent that "guaranteed payments" are made the effect is the same as salaries in a corporation.

The touchstone of determining "guaranteed payments" is whether they are payable without regard to partnership income. And, in determining whether in a particular case an amount paid by a partnership to a partner is a "drawing" or a "guaranteed payment," the substance of the transaction, rather than the form, must govern.

The greatest advantage of the partnership form to Smith Electric Company is the tax advantage with respect to likely losses during the retooling and research and development phase of the new operation. Such losses, if sustained by a corporation, would not be available to

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106 337 U.S. 733 (1949).
107 Id. at 742.
the owners except through subchapter S or (upon sale of common stock) through section 1244 treatment. If substantial preferred stock were employed, subchapter S would not be available, and section 1244 would apply only to the common stock.

The partnership not only passes the losses to its members, but by virtue of section 704(b) the partnership agreement may treat income or loss emanating from different sources in a different manner so long as the purpose is not the avoidance or evasion of tax. The Regulations point out that consideration will be given to whether there is a business purpose for the allocation, whether it has "substantial economic effect," whether the allocation is consistently applied, and its duration and overall tax consequences. One illustration in the Regulations has particular relevancy to the Smith partnership:

G and H enter into a partnership agreement to develop and market an electronic device. H, an electronics engineer, contributes $2,500 cash and agrees to devote his full-time services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 per cent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was avoidance or evasion.

Properly and fairly applied, the partnership agreement could allocate the interest on business loans as well as the greater amount of the research and development expenses to Smith's capital account and give him a large percentage of income or loss for a limited period. If losses are realized, the effect will be to allocate the largest part of those losses to Smith and to reduce his capital account by the amount of interest and research and development expenses. Thus, when the business becomes profitable, Smith has a loss carry-forward (if the losses exceeded his other income), and the sons have acquired a

greater relative capital share in the business without the necessity of gifts to them. Another item qualifying for special allocation in the partnership agreement under section 704(a) would be the accounts receivable transferred to the partnership by Smith. The income from the transferred accounts receivable will constitute ordinary income because they have a zero cost base and are transferred to the partnership at the transferor's cost base. Thus while ordinarily Smith would wish to have this item of ordinary income allocated among all the partners, it may be possible that research and development expenses and general operating losses will be so great that he would want to have collections on these accounts receivable allocated to him. In the case of a sale of an unincorporated business the contract frequently excludes accounts receivable, but there is a strong business reason to maintain continuity of relationship with the customers. This provision of the tax laws permits the partnership to enjoy the advantage of their inclusion as assets for balance sheet purposes, assures a continuity of relationship with the old customers, but allows Smith to enjoy the proceeds realized upon their collection and thus allows recognition of economic realities.

Section 704 has a second optional allocation provision that would fit the Smith plan.

If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.iii

Since machinery and equipment have been fully depreciated, any sale of it could well result in a gain, and Smith might wish to have such gains allocated to himself since he contributed these items to the partnership. The agreement could so provide.

One caveat is in order. There is a limit on the distributive share of partnership loss which Smith may deduct on his income tax return: the loss may not reduce his adjusted basis below the amount thereof as of the close of the tax year, but the excess of any such loss is not dissipated, it is carried forward.112 Unlike other types of loss carry-forward, it continues indefinitely, at least as long as the partnership continues.

While it is true that all partners in Smith Electric Company will

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112 Treas. Reg. § 1.704-1(d) (1956).
start with relatively low capital accounts (and Smith's may be heavily reduced by the agreement allocating disproportionate loss items to him), the cost base of Smith's interest in the partnership will be increased by the necessary bank borrowing to obtain new working capital.\(^{118}\) Thus Smith's share of bank loans will have the same effect on basis as a like contribution of money by him, and the amount against which his share of losses can be applied will likewise increase by his share of such indebtedness.

As pointed out above, paid-up stock may not be issued to Richard (or John) for future services, but a capital account may be created in a partnership in consideration of a contract to perform future services.\(^{114}\)

Much is commonly said of the retirement benefits of working for a corporation. While it is true that the profit-sharing and pension plans afforded the corporation are attractive,\(^ {115}\) there are some provisions available to the Smith partnership also. If the business was incorporated, redemption of all or any part of Smith's stock upon retirement or death at capital gains rates would present serious problems under section 302 because of the attribution of ownership rules of section 318. With the partnership form, greater flexibility is afforded on death or retirement, and the remaining partners may obtain a stepped-up basis. The partnership agreement could provide for a retirement program under which a guaranteed payment could be made to Smith for life\(^{118}\) which would qualify as a partnership deduction pursuant to section 707(c) and would constitute ordinary income to him. In addition, his interest in the partnership can be liquidated in a single payment or over a period of years at capital gains rates except to the extent that the payments are made for unrealized receivables, which portion the retiring partner must treat as ordinary income, and except as to excess over basis of "substantially appreciated inventory items."\(^ {117}\) If the agreement so provides, a reasonable value can be ascribed to good will.\(^ {118}\) The retiring partner's interest in inventory

\(^{113}\) Int. Rev. Code of 1954, § 752. There is a dichotomy in the accounting sense between the capital account of a partner and the basis of his interest in the partnership. One instance of this is in connection with § 752 where a liability of the partnership will increase the partner's basis but will not increase his capital account.


\(^{117}\) Items aggregating 10% of the fair market value of all partnership property and having a fair market value in excess of 120% of their basis to the partnership are "substantially appreciated." Int. Rev. Code of 1954, § 751(d).

\(^{118}\) Treas. Reg. § 1.736-1(b)(3) (1956).
is likewise converted to capital gains under this provision of the Code except as to excess over partnership basis of "substantially appreciated inventory items."

John and Richard can elect to adjust the bases of the remaining property to reflect the gain paid Smith and the payments made with respect to unrealized receivables and substantially appreciated inventory. These changes in bases have no counterpart in the corporate entity when stock is redeemed and could be of great advantage to John and Richard in reducing income realized on receivables and inventory and creating new depreciation on depreciable property.

Conclusion

The facts assumed in the Smith case were formulated to avoid a clearly indicated choice of business form. To this extent they are typical of many small businesses whose owners are debating the question of whether or not to incorporate.

Let us assume that Smith and his wife Mary agree: (1) that certain group insurance policies are community by reason of payment of premiums from earnings, and that these policies are to be made payable to Mary to assure her an adequate cash reserve; (2) that the balance of Smith's non-business assets are his separate property; (3) that the business real property has a value in excess of the community share of the total business assets under either formula; and (4) that whether Smith incorporates the business or creates a partnership the real property is not to be a business asset but is to be leased to the business by long term lease. Smith and Mary decide to create an irrevocable inter vivos trust of the property to assure single management, income to the spouses during their joint lives, and income to the survivor of them. Upon death of the survivor the trust terminates and the trustee is directed to sell the property, unless all remaindermen direct distribution in kind, and to distribute the assets one half to Smith's children and the other half to Mary's designated remaindermen.

If Smith's personal assets are adequate to cover death taxes, he is now in the clear to proceed with planning. If they are insufficient,
his plans must include provision for liquidation of a portion of his business interests, or possibly more life insurance.

Had Mary been unwilling to cooperate, Smith might have found that the corporate form of business would afford less chance of disruption after his death, since under no circumstances would his ownership represent less than the controlling interest in the corporation. While he could not in that event lease the real property to the new business form without Mary’s joining in the lease, he could rent it to the business on a month-to-month tenancy. And while he could not give stock to his children, he could sell it at fair market value and loan them the money to buy; the stock sold plus that over which he had testamentary power would always represent substantial control of the corporation.

Because of the strong possibility of a number of loss years resulting from the expansion program of Smith Electric Company, a partnership would seem to be the best choice of form for the early years. But because the conditions underlying the decision as to form can change from year to year, a constant review should be made to determine at what point the corporate form may offer the most advantages. The obvious change-over occurs when the aggregate of corporation and individual income taxes is less for the corporate form than for the partnership, but even there caution should be used because, for example, there may be difficulties in redeeming Smith’s stock because of attribution rules.

Other factors will bear upon the testing procedure. As the business grows and becomes more sophisticated the partnership will encounter increasing difficulties in hiring and retaining highly qualified personnel, for it will be in competition with corporate employers having profit-sharing and retirement plans on more advantageous terms and qualified stock option plans for executive personnel which have no counterpart in the unincorporated business.

It would be presumptuous to attempt to discuss all of the factors that should be considered in choosing the business form. What has been attempted is to explore some of the advantages and disadvantages that are not at all apparent to the owner of the business, to assist him in avoiding undue emphasis on supposed advantage which is minimal or nonexistent, to advise him on a course of procedure that will involve the least expense and greatest certainty, and to avoid a selection that could prove costly if later conditions required a change of form.

In the introduction it was stated that any planning in this field must be coordinated with Smith’s estate planning. Only cursory refer-
ence has been made to this vital element, though the decision as to
treatment of certain items of property must of necessity be affected
by the nature of the property and Smith's plans for eventual disposition
of it. Whether Smith chooses the corporate form or the partnership,
it is clear that the sons will be the prime benefactors of business
success. Since their personal efforts will contribute to that success, it
is only proper that their rewards should be commensurate, but Smith
will undoubtedly wish to make other provisions for his daughter Karen
by annual gifts, inter vivos trust, will, or a combination of these
methods. The close coordination of estate planning with selection of
business form will be a continuing project.