A Tax Comparison of the Limited Partnership and the Subchapter S Corporation

Minn. L. Rev. Editorial Board

Follow this and additional works at: https://scholarship.law.umn.edu/mlr
Part of the Law Commons

Recommended Citation
https://scholarship.law.umn.edu/mlr/2760

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.
A Tax Comparison of the Limited Partnership and the Subchapter S Corporation

This Note compares the limited partnership with the new Subchapter S corporation. The author analyzes each as a method for obtaining corporate advantages without incurring federal corporate taxation. He also examines the practical implications of each as an income splitting device.

INTRODUCTION

The limited partnership is an unincorporated business form possessing, by the grace of statutes in all states, a combination of characteristics which at common law were peculiar to either the corporation or the partnership. Businessmen have found this statutory form of organization suitable for three purposes. First, it can be used to avoid corporate taxation while securing some corporate business advantages. Second, it is well suited as a device for splitting income among family members to obtain in some instances a family tax lower than that which would be paid by one member if all the family income were taxable to him. Finally, the limited partnership has been selected by associates such as doctors and stock brokers who, by law, are precluded from incorporating.

In the last moments of the 84th Congress, Subchapter S was enacted into the Internal Revenue Code creating a new tax entity, 1.

1. Thirty-eight states have adopted the Uniform Limited Partnership Act. UNIFORM LIMITED PARTNERSHIP ACT, 8 U.L.A. 6 (Supp. 1958). Those states which have not adopted the Uniform Limited Partnership Act have statutes similar in substance. See ALA. CODE tit. 43, §§ 6–27 (1940); CONN. GEN. STAT. §§ 6270–84 (1949); DEL. CODE ANN. tit. 6, §§ 1701–13 (1953); KAN. GEN. STAT. ANN. §§ 56–101 to –21 (1949); KY. REV. STAT. §§ 362.010–130 (Baldwin 1955); LA. CIV. CODE ANN. arts. 2839–51 (West 1952); ME. REV. STAT. ANN. ch. 181, §§ 17–20 (1954); MISS. CODE ANN. §§ 5553–70 (1956); N.D. REV. CODE §§ 45–0301 to –320 (1943); ORE. REV. STAT. §§ 69.010–130 (1957); S.C. CODE §§ 52–101 to –128 (1952); WYO. COMP. STAT. ANN. §§ 61–701 to –725 (1945). The limited partnership is not governed by business corporation statutes. E.g., MINN. STAT. §§ 322.01–16 (1957).

2. The limited partnership did not exist at common law. It was developed in Italy and France to enable wealthy noblemen to invest in commercial enterprises without the responsibility of active management or unlimited liability. A limited partnership act was first introduced in this country in New York in 1822. The act was modelled after the French Société en Commandite, and served as a model for other states' acts until the Uniform Limited Partnership Act was prepared in 1916. Lewis, The Uniform Limited Partnership Act, 65 U. PA. L. REV. 715, 716–17 (1917); Comment, 45 YALE L.J. 895 (1936).

3. For example, in 1949 40% of the stock brokerage firms on the New York Stock Exchange had limited partners. John A. Morris, 13 T.C. 1020, 1027 (1949).
the corporation which elects not to be subject to corporate taxes. Having made the election, the corporation is relieved of the federal corporate income tax burden while it can retain the business advantages it might enjoy under state commercial laws. Furthermore, through the use of a family corporation electing under Subchapter S, profits may be allocated among family members without incurring the cost of double taxation. At first glance, then, Subchapter S challenges the usefulness of the limited partnership by presenting an alternative which offers greater business advantages than the limited partnership in a form with which banks, creditors, and investors are well acquainted. This challenge is the subject of this Note.

The scope of this Note is limited to a discussion of the comparative usefulness of an electing corporation and a limited partnership (1) for the purposes of obtaining corporate business advantages without incurring federal corporate taxes; and (2) as income splitting devices. Consequently, this Note will not discuss the relative merits of each in estate planning, under state tax laws, and in organization and dissolution.

I. CORPORATE ADVANTAGES WITHOUT CORPORATE TAXATION

The avoidance of corporate taxation is the aim mainly of business organizations which do not require substantial reinvestment of earnings, or those which do require substantial reinvestment but whose members' marginal tax brackets are less than the tax bracket applicable to the organization's expected profits. The organization can sometimes avoid corporate income taxes by distributing its total earnings to the owners through tax deductible payments, such as salaries, rents, and interest payments. However, these plans are often unsuccessful, first because they require an accurate prediction of future profits, and second because courts may deem the distributions nondeductible dividends to capital owners.

4. Because the limited partnership is a somewhat unfamiliar business form, difficulties may be encountered in using that form. See Katz, A Common Fallacy Respecting Limited Partnerships, 20 Calif. S.B.J. 105, 109 (1945).

5. State income tax considerations may be of great importance in selecting a business form in a particular state. For example, Minnesota does not have a statute comparable to Subchapter S. Consequently the electing corporation will be subject to Minnesota's corporate taxes, and the shareholders will not be allowed a deduction for federal taxes paid on corporate earnings which are not actually received. Commissioner's Release, Jan. 28, 1958, 2 CCH State Tax Rep. Minn. ¶ 200-045 (1958); see Minn. Stat. § 290.10(9) (1957) (no deduction allowed for taxes paid on income which is not includible in gross income for state tax purposes).

6. See, e.g., Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 880 (1958) and cases cited therein where attempted debt financing of a close corporation's dominant shareholders has been struck down as constituting contribution to capital.
Corporate tax can also be avoided by an election under Subchapter S, if available, or by the adoption of a form of business organization which is not classified as a corporation for tax purposes. Though there are many criteria for choosing between these two methods, one important consideration is the availability of corporate business advantages in each method.

The limited partnership is an unincorporated business organization which enjoys many business advantages similar to those of the corporation while avoiding the corporate classification under federal tax law. The problem in the use of this form of organization is to determine which business advantages can exist and to what extent they may exist without leading to the classification of association, taxable as a corporation.

The problems in using Subchapter S to avoid corporate taxes are different from those of the limited partnership, for an electing corporation retains all the local law business advantages of a non-electing corporation. However, some unique problems arise from possible termination of the Subchapter S election and ensuing loss of the corporation's tax-free status. This section of the Note will first examine the nature of the limited partnership, its classification for tax purposes, and the opportunity it presents for obtaining corporate business advantages without incurring corporate taxation; and then will discuss the taxation of Subchapter S corporations and their shareholders, and some problems which electing corporations will encounter in retaining corporate business advantages.

A. Limited partnership

(1) Nature

The limited partnership formed under the Uniform Limited Partnership Act consists of one or more general partners and one or more limited partners. Each general partner is both an agent-manager of the partnership for partnership business, and the principal of his fellow general partners. He is fully liable for the business debts of the partnership. Upon his incapacity to fulfill his managerial or financial responsibilities, the partnership is dissolved unless the remaining general partners elect to continue the business under provision of the limited partnership agreement.

7. Uniform Limited Partnership Act § 1. [Hereinafter referred to as U.L.P.A.]
8. U.L.P.A. § 9 (rights and duties of a general partner are the same as a partner without limited partners); Uniform Partnership Act § 9 (every partner is an agent of the partnership for partnership business).
limited partner on the other hand, takes no active part in managing the business. His limited authority gives him rights only to inspect partnership books, to demand and receive, when reasonable, full information regarding "all things affecting the partnership," to receive his share of the profits, and to receive his share of capital upon dissolution or at the time stated in the partnership agreement. The limited partner who acts in good faith is liable for the debts of the partnership only to the extent of his capital contribution. However, under the Uniform Limited Partnership Act he is liable as a general partner if in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. In many respects the status of a limited partner is similar to that of a corporate stockholder: the interest of existing limited partners may be assigned, the death or insolvency of a limited partner will not dissolve the partnership, and additional limited partners can be brought into the organization at any time.

Thus, the limited partnership is a hybrid organization consisting of general partners whose rights and duties are similar to those of partners in a common law partnership and limited partners whose rights and duties are similar to those of nonvoting corporate shareholders.

(2) Tax classification

For income tax purposes the Internal Revenue Code generally classifies business organizations which have more than one beneficial owner as corporations, partnerships or trusts, unless they are financial institutions or specially exempt organizations. While the limited partnership is a business organization which must have more than one beneficial owner, it is not expressly included within any of these three classifications. However, the Code's definitions of both the corporation and the partnership are broad enough to include the limited partnership. The Code's definition of corpora-
tion includes unincorporated "associations," while partnership is defined as the residue of unincorporated organizations which are not "associations." Therefore, the tax classification of limited partnerships turns upon the word "association" which is not defined in the Code but left for the courts and Treasury Regulations to interpret.18

In 1936, after a period of confusion and inconsistent opinions in the lower courts,19 the Supreme Court in Morrissey v. Commissioner20 defined association as an unincorporated group of associates doing business in a manner similar to that of a corporation. The Court said that similarity to the corporate manner is a fact evidenced by six corporate attributes: (1) liability of the members limited to the amount of their original contribution, (2) continuity of business activity, uninterrupted by death, bankruptcy or insolvency of the members, (3) management of business activities centralized in a representative body, (4) free transferability of interests, (5) ownership of business property by the organization itself, and (6) use of particular rituals and terminology of corporations.21

The Morrissey test has been applied almost uniformly by courts in subsequent cases determining the tax classification of unincorporated organizations.22 In doing so, these courts have looked to the terms of the agreement between the members,23 local law governing or a corporation. ... " "The Term 'corporation' includes associations, joint stock companies, and insurance companies." INT. REV. CODE OF 1954, § 7701(a)(2), (3). [Hereinafter referred to as I.R.C.]


20. 296 U.S. 344 (1935). Accompanying this case were three companion cases applying the Morrissey doctrine to different fact situations. Swanson v. Commissioner, 296 U.S. 362 (1935); Helvering v. Combs, 296 U.S. 365 (1935); Helvering v. Coleman-Gilbert Associates, 296 U.S. 369 (1935). All four cases involved the tax classification of organizations claiming to be trusts but the doctrine is applicable to all unincorporated organizations.

21. Morrissey v. Commissioner, 296 U.S. 344, 359 (1935). The test of title held by the organization has not been held applicable in cases deciding the tax status of partnerships on the reasoning that partnerships generally do hold title to property. Vernon, When Are Partnerships Likely To be Taxed as Associations?, N.Y.U. 4TH INST. ON FED. TAX, 469, 507 (1945). The rituals and forms test was expressly rejected by Morrissey as an important factor in classification and therefore will not be separately discussed in this Note. However, since this factor may be of some weight, it is wise for the draftsman of a limited partnership agreement to avoid corporate rituals when they are unnecessary.

22. See, e.g., United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); but see, Guaranty Employee Ass'n v. United States, 241 F.2d 565 (5th Cir. 1957), where the court purported not to rely on Morrissey although, in reality, it did utilize Morrissey corporate attributes in making its determination.

the entity, and any other relevant circumstances. But because of the endless number of forms an unincorporated organization may assume, there is no general rule to determine what combination of corporate attributes will result in classification as an association. Nevertheless, since limited partnership agreements must be drafted in accordance with and governed by local statutes which are almost uniform throughout the country, past classifications have value for predicting the classification of other limited partnerships.

In the leading case of *Glensder Textile Co.*, the Board of Tax Appeals determined for the first time the tax classification of a limited partnership under the *Morrissey* test. This partnership, formed under the Uniform Limited Partnership Act of New York, consisted of four general partners collectively owning a five-twelfths interest in profits and property, and nine limited partners owning the remaining interest. Under the New York act, management duties were centralized in the general partners, the limited partners possessed limited liability, and the partnership was not interrupted by the death, insanity or insolvency of a limited partner. In addition, the partnership agreement granted limited partners the right to fully assign their interests; general partners were given the right to add limited partners and to elect to continue the business on the "death, retirement or insanity of a general partner." At first glance, this partnership appeared to have four of the *Morrissey* corporate features: transferable interests, limited liability, continuing existence, and centralized management. But the court distinguished each of these features from those of a corporation. To distinguish the first three features, the court emphasized that the general partners' interests were not transferable, that their liabilities


25. While the plea of the associates must rest solely on their agreement, the government may be able to contradict the terms of the agreement with evidence of actual happenings. Compare Helvering v. Coleman-Gilbert Associates, 296 U.S. 369, 374 (1935), and Wholesalers Adjustment Co. v. Commissioner, 88 F.2d 156 (8th Cir. 1937), with Del Mar Addition v. Commissioner, 113 F.2d 410 (5th Cir. 1940), and Huron River Syndicate, 44 B.T.A. 859 (1941).

26. It is universally recognized that not all the corporate features need be present. See, e.g., Del Mar Addition v. Commissioner, 113 F.2d 410 (5th Cir. 1940). To establish the *Morrissey* doctrine, the court selected four cases each found to possess all of *Morrissey*'s "salient features." The selection may have been made in order to avoid showing any comparative weight of the features.

27. See statutes cited in note 1 supra.


30. 46 B.T.A. at 185.
were unlimited, and that their deaths would cause a conditional dissolution. The court distinguished the fourth feature—centralized management—by reasoning that because the general partners owned a large interest in the partnership they were acting in their own behalf, unlike corporate directors who represent the stockholders. Consequently, the court held that the organization was not an association taxable as a corporation.

There have been only two other cases which have adjudicated the tax classification of limited partnerships; in each of these cases the limited partnership was similar in form to the one in *Glensder* and was found not to be an association.\(^3\) From the uniformity of this litigation it should be safe to predict that limited partnerships with no more corporate similarity than *Glensder* presented, formed in accordance with acts similar to the New York Uniform Limited Partnership Act, will be classified for tax purposes as partnerships. However, the tax classification of limited partnerships with corporate similarity in excess of that found in *Glensder* is still uncertain. Therefore, the business which contemplates organizing as a limited partnership for the purpose of gaining more tax free corporate similarity, in one or more particulars, than that existing in *Glensder*, will find useful an analysis of the probable effect of each corporate feature upon tax classification.

(3) Business advantages

(a) Continuity. It is clear from *Glensder* that the power of the general partners to continue the business in the event of “death of a general partner or by a change in the ownership in his participating interest” does not create corporate similarity for the purpose of tax classification; for continuity conditioned upon the election of the general partners was distinguished from the certainty of business continuity of the corporation.\(^3\) Nor does the power of the general partners to admit additional limited partners create corporate similarity.\(^3\)

The general partners probably may also bind themselves legally by an agreement to elect to continue the partnership upon the death of a general partner.\(^3\) However, the presence of such an agreement would take the organization outside the *Glensder* reasoning that the continuity of the organization was conditioned upon the will of the general partners and therefore unlike the certainty of a corporation’s continual existence. Furthermore, under

\(^3\) Western Construction Co., 14 T.C. 453 (1950); Taywal Ltd., 11 P-H Tax Ct. Mem. 1044 (1942).
\(^3\) 46 B.T.A. at 185.
\(^3\) Id. at 185; Taywal Ltd., 11 P-H Tax Ct. 1044, 1045 (1942).
Treasury Regulations, limited partnerships are classified as associations if their management is centralized, and they are not "interrupted by the death of a general partner or by a change in the ownership of his participating interest. . . . " In view of this emphasis placed upon continuity and Glensder's distinction based upon the uncertainty of the general partners' election to continue, it follows that any restraint on the right not to continue upon the death, insolvency or incapacity of a general partner is likely to be considered strong evidence that the organization has sufficient corporate similarity for tax purposes.

(b) Centralized management. The Glensder court gave great weight to the fact that the general partners owned a five-twelfths interest in capital and profits, reasoning from this that they were acting not in a representative capacity but in their own behalf. In dictum the court stated that if the general partners did not own a large interest the organization would be an association taxable as a corporation. However, this dictum, which has never been tested, may be an invalid interpretation of the Morrissey doctrine which declares centralization of management in a representative body to be evidence of corporate similarity. Whether the general partners are acting in a representative capacity depends in reality not upon the size of the general partners' interest, but upon the power vested in the limited partners to subject the general partners to their will. The Uniform Limited Partnership Act vests full management power in the general partners; unless this power is restricted by an agreement or by the circumstances of the parties, the limited partners have no power to direct the actions of the general partners. General partners will always be free to act in the furtherance of their own profit interest regardless of the size of their capital interest. A more reasonable test would be one turning on the actual power of the limited partners over the management by the general partners. Should future courts adopt this test, so long as the powers of the general partner are not restricted beyond the minor

36. 46 B.T.A. at 185.
37. If, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real meaning acting as agents of the limited partners whose investment made possible the business, there would be something approaching the corporate form of stockholder and directors.
38. For example, if the general partner's interest was earning a very small amount, but he was also employed as an attorney for the limited partners who paid him a very large retainer, circumstances would give the limited partners control over the general partner forcing him to act in a representative manner.
limitations imposed by the act, control can probably be centralized beyond that found in *Glensder* without leading to the imposition of corporate taxes.\(^3\)

(c) **Transferability.** For federal income tax purposes transferability of an ownership interest is evidence of an association taxable as a corporation, while obstructions on alienability are evidence of a partnership.\(^4\) Such obstructions might be found in the requirement that the interest must first be offered to the existing partners\(^5\) or the fact that the absence of formal certificates makes transfer difficult.\(^6\) The court in *Glensder* adopted a narrow view as to what interests are readily and freely transferable. There the limited partners were vested by the agreement with power to convey their entire interest. The court distinguished this power from the power of corporate stockholders to convey their interest, on the questionable grounds that though the assignor possessed full power to convey all his rights, he was not required to convey his right to inspect the partnership books and demand partnership information. To strengthen its finding, the court observed that the limited partnership interests were not represented by formal written certificates and, therefore, as a practical matter, they were not easily transferred.\(^7\)

In all three cases under the *Morrissey* doctrine, the general partners lacked power to admit their assignees as general partners.\(^8\) Using the reasoning applied to transfer of the limited partners’ interests, the power of a general partner to assign all his rights should have no effect on the classification, since he could assign something less. However, an important element of the *Glensder* decision was the fact that the general partners closely resembled “partners in a partnership without limited partners,” and any deviation from this resemblance may cause a classification of “association.”

(d) **Limited liability.** In the cases determining the classification of

---

39. In fact, one author suggests that the Internal Revenue Service, itself, does not require the general partners to possess a large capital interest if they are contributing substantial services to the partnership, so long as they exercise complete management control. *Heard, New Tax Advantage in the Creation and Operation of Limited Partnerships, in Tax Planning Under the New Regulations* 50 (1957).
40. Poplar Bluff Printing Co. v. Commissioner, 149 F.2d 1016 (8th Cir. 1945); George Bros. & Co., 41 B.T.A. 287 (1940).
42. Commissioner v. Gerstle, 95 F.2d 587 (9th Cir. 1938) (trust case); Glensder Textile Co., 46 B.T.A. 176 (1942); *contra*, Commissioner v. Fortney Oil Co., 125 F.2d 982, 985 (6th Cir. 1942).
43. 46 B.T.A. at 186.
44. Western Construction Co., 14 T.C. 453 (1950); Taywal Ltd., 11 P–H Tax Ct. Mem. 1044 (1942); Glensder Textile Co., 46 B.T.A. 176 (1942) (could only assign on the limited partners’ consent).
limited partnerships for tax purposes, the unlimited liability of the general partners has been emphasized. Correspondingly, when a "limited partnership association" has been classified, emphasis has been on the fact that in those organizations the liability of all members is limited. Thus, in partnership cases complete limited liability is an important factor, and if the general partners in a limited partnership had so few assets that in reality there was complete limited liability of all partners, this might be evidence of an association.

CONCLUSION TO LIMITED PARTNERSHIP

The business advantages offered by the limited partnership must be judged separately from the viewpoint of the limited and the general partners. The limited partner has many of the advantages of a corporate shareholder, for he has a share in the profits of the business, his liability is limited to his original investment, his interest is usually freely transferable and he has the right to inspect the partnership books. One important right which the limited partner does not possess is the right to select management and take part in the formation of partnership business. Thus, the security of his investment necessarily rests upon the business ability and integrity of the general partners. The general partner has fewer business advantages for he is subject to unlimited liability and his interest is not completely transferable. However, he does have complete control of management and may continue the business regardless of the death, insanity or insolvency of any other partner if the partnership agreement so provides.

Although these advantages may exist to some degree without causing corporate similarity for tax purposes, it is impossible to determine exactly what combination of characteristics will create sufficient corporate similarity to justify corporate taxation. Nevertheless, it is clear that corporate similarity is judged upon not only the presence or absence of corporate features but also upon the degree to which one or more features exist. For example, if the partnership were to issue one hundred written certificates each representing a one per cent ownership and each transferable by endorsement only, strong evidence of corporate similarity would be

46. The limited partnership association is a business form existing in only four states—Michigan, New Jersey, Ohio, and Pennsylvania. This form differs from the limited partnership in that all members possess unlimited liability and rights in the management of the business. See statutes and authorities collected in Note, 45 Minn. L. Rev. 305, 317 nn. 58–62 (1958).
47. E.g., Giant Auto Parts, Ltd., 13 T.C. 307 (1949).
created. Therefore, unless this or similar procedures are of particular desirability to the investors, they should be avoided. The draftsman should select only those corporate features which are essential to the investors, and these should be incorporated into the agreement only to the degree necessary to fulfill the immediate purpose.

B. Subchapter S

(1) Nature

Subchapter S is frequently said to allow a corporation to be taxed as a partnership. This is a misconception which confuses the interpretation of a new and consequently unfamiliar tax concept. It is clear from legislative history that Congress did not intend that a corporation electing under Subchapter S be taxed as a partnership. The electing corporation remains subject to all corporate provisions of the Code which are not expressly made inapplicable by the provisions of Subchapter S. Essentially, the election offered to corporate shareholders is to include in their gross income the taxable income of the corporation, computed as for any nonelecting corporation, in lieu of the payment of corporate income tax.

(2) Tax provisions

(a) Election and termination. The Subchapter S election is available to any corporation qualifying as a "small business corporation," which by definition is a (1) domestic corporation, not a member of an affiliated group, which has only one class of stock, owned by shareholders who are all residents or citizens of the United States and who number not more than ten. To prevent

49. In 1954 the Senate proposed two new sections to the Code which were intended to enable certain small business organizations to select their business form without consideration of tax consequences. S. Rep. No. 1622, 83rd Cong., 2d Sess. 118 (1954). The proposed § 1361 which enabled certain partnerships to elect to be taxed as corporations was enacted into the Code as Subchapter R (§ 1361). On the other hand, the Conference Committee rejected the complementary provision, § 1351, which enabled certain corporations to elect to be taxed in accordance with the partnership provisions of Subchapter K. See S. Rep. No. 1622, 83d Cong., 2d Sess. 118 (1954). The proposed § 1361 which enabled certain partnerships to elect to be taxed as corporations was enacted into the Code as Subchapter R (§ 1361). On the other hand, the Conference Committee rejected the complementary provision, § 1351, which enabled certain corporations to elect to be taxed in accordance with the partnership provisions of Subchapter K. See S. Rep. No. 1622, 83d Cong., 2d Sess. 118 (1954); Frost, New Election of Certain Corporations Not To Be Taxed as Such, 45 A.B.A.J. 81 (1958). Subsequently, in 1958 Congress enacted Subchapter S to fulfill its original purpose. S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958). However, the provisions of the new Subchapter fundamentally differ from those rejected in 1954; they do not provide that an electing corporation changes its tax classification to that of a partnership.

50. I.R.C. § 1371(a).

51. "The term 'domestic' when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State or Territory." I.R.C. § 7701(a)(4).

52. The definition of "affiliated group" given in § 1504(a) of the 1954 Code is incorporated into Subchapter S. I.R.C. § 1371(a).
frustration of the ten shareholder requirement, (6) all shareholders must be individuals or estates.\(^5\)

Formally the election is made by the "small business corporation," but it is valid only upon the written consent of all shareholders of record on the first day of the first taxable year for which the election is to be effective, or, if the election is made subsequent to that day, on the day of the election.\(^6\) The election can be validly made in the first month of a taxable year or in the preceding month, and once made the election is effective for that taxable year and all subsequent taxable years unless it is either terminated by law or voluntarily revoked.\(^5\)

Termination by law occurs whenever the corporation ceases to be a "small business corporation."\(^6\) However, if the corporation elects prior to the first election year, the corporation must be a small business corporation only during the election year. The election is also terminated by law if a new shareholder enters the corporation and fails to consent in writing to the election within thirty days.\(^5\) Finally, the election terminates by law if the corporation derives more than eighty percent of its gross receipts from foreign sources, or more than twenty percent of its gross receipts as a "personal holding company," from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.\(^5\)

The corporation may voluntarily revoke the election for any taxable year subsequent to the first year, with the unanimous consent of all shareholders, and only if the revocation is made before the end of the first month of that year.\(^5\) However because the election is terminated by law if the corporation ceases to be a "small business corporation" or if a new shareholder enters and does not consent, voluntary termination may be indirectly accomplished for any taxable year at any time during the year if one shareholder transfers shares to a person or organization who will cause a termination by law.\(^6\)

(b) Taxation of the shareholders. Each shareholder of an electing

---

53. "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." I.R.C. § 7701(a) (1). Thus, by requiring that all shareholders be individuals, Congress has eliminated corporations whose shareholders include "a trust, . . . partnership, association, company or corporation."

54. I.R.C. § 1372(a).

55. I.R.C. §§ 1372(e), (d).

56. I.R.C. § 1372(e)(3).

57. I.R.C. § 1372(e)(1); T.D. 6317, 1958 INT. REV. BULL. No. 41, at 77.

58. I.R.C. §§ 1372(e)(4), (5).

59. I.R.C. § 1372(e)(2).

corporation must include all dividend distributions in his own gross income. In accordance with section 316 of the Internal Revenue Code, distributions of money or other property are dividend distributions to the extent of the undistributed earnings and profits of the current year plus any accumulated earnings of prior non-electing years. However, distributions either out of capital or the earnings of prior electing years are not dividends and therefore not included in gross income.

In addition to actual dividend distributions, Subchapter S creates a pro rata constructive distribution on the last day of the corporation's taxable year. The constructive distribution is equal in amount to the corporation's undistributed taxable income, that is the corporation's taxable income less actual dividends of money which, as has been seen, are taxed separately as 316 dividends paid during the year. The shareholder includes in his income that portion of the constructive distribution which he would have received as a dividend out of current and accumulated earnings had those amounts actually been distributed. This rather complicated method of computing the amount includible in a shareholder's income is unnecessary if the corporation makes only cash distributions during the year. For this situation the rule could simply be stated that the shareholder includes in his gross income his pro rata share of the corporation's undistributed taxable income. However, where property distributions are made the more complicated method is necessary, because dividends of property other than money do not reduce the size of the constructive distribution. Thus, if taxable income equals current earnings and profits, the constructive distribution will exceed in amount undistributed current earnings and profits by the value of any property distribution assuming that value and basis are the same. In accordance with the proposed regulations, this excess must be included in the shareholders gross income to the extent the corporation has accumulated earnings. This result follows because, if the corporation has no accumulated earnings, the excess would not have been received as a dividend and therefore is not includible in gross income.

62. Undistributed taxable earnings of prior electing years are not a part of accumulated earnings. I.R.C. § 1377(a).
63. I.R.C. § 1373(b).
64. I.R.C. § 1373(d).
65. Compare I.R.C. § 1373(c), with I.R.C. §§ 316(a), 317(a).
66. A corporate distribution of property other than money generally reduces current earnings and profits by the adjusted basis to the corporation of the property distributed. I.R.C. § 312(a).
Suppose, for example, an electing corporation has accumulated earnings of $5,000, and current earnings and profits and taxable income of $10,000. If a cash distribution of $6,000 is made, the shareholder must include in gross income his share of the $6,000 dividend, for that entire amount would have been taxable as a distribution from earnings and profits of the current year. In addition, each shareholder must include his share of the $4,000 "undistributed taxable income" ($10,000 taxable income minus $6,000 of dividends of money from current earnings) on the last day of the corporation's taxable year. Had that $4,000 been distributed it would have been a dividend from current earnings and profits.

If instead of distributing cash the corporation distributes property with a fair market value and basis of $6,000, the shareholder must again include his share of the $6,000 in gross income as a dividend from current earnings. However, the additional amount that must be included in his income is a pro rata share of $9,000; had an amount been distributed equal to the "undistributed taxable income," which is $10,000 since there are no money dividends to be subtracted from the corporation's taxable income, the first $4,000 would have been includible as a dividend from current earnings, the next $5,000 would also have been includible as a dividend from accumulated earnings; but the last $1,000 would have been treated as a nonincludible capital distribution so long as it did not exceed the shareholders' basis of the stock. If both cash and property distributions were made during the year, the cash would reduce current earnings and profits first. This example illustrates that distributions of property by an electing corporation which has accumulated earnings are generally inadvisable.

In order to make the foregoing computations, the taxable income of the electing corporation must be determined. This is determined without taking net operating loss deductions or the special corporate deductions under part VIII of Subchapter B. But aside

---

68. If property other than money is distributed to noncorporate distributees the amount which is received equals the fair market value of the distribution. IRC. § 301(b)(1)(A).
69. All distributions are considered to be from current earnings and profits to their extent and then from the most recently accumulated earnings. IRC. § 316(a).
70. If the corporation has distributed total current earnings and accumulated earnings, additional distributions are considered to be from capital. If the distribution exceeds the shareholder's basis of his stock, the excess is treated as capital gain. IRC. § 301(c).
71. IRC. § 1573(d). The deductions which are not allowed are (1) net operating loss deduction, IRC. § 172; (2) deduction of interest on federal government obligations when the interest is exempt from tax by the authorizing act, IRC. § 242(a); (3) 85% dividend received deduction, IRC. § 243; (4) a partial deduction of dividends received from preferred stock of public utilities, IRC. §§ 244, 247; (5) a partial deduction of dividends received from foreign corporations, IRC. § 245.
from these, there are no special provisions for computing the taxable income of an electing corporation, and it is computed in the same manner as the taxable income of a corporation which does not come under the provisions of Subchapter S. For example, the electing corporation is free to reduce taxable income by amounts equal to fringe benefit deductions allowed to nonelecting corporations. It could be objected that since the employee-owners are taxed for all practical purposes as partners in the enterprise, the corporation should not get the benefit of deducting from taxable income benefits paid to or for the employee-owners. But, had Congress intended this result it could have either added the fringe benefit deductions to those expressly excluded or adopted the form of Subchapter R by providing that electing corporations be taxed as partnerships.

Another problem the shareholder will face in determining the amount of the tax he must pay on the electing corporation's income is the proper characterization of the income in his hands. On most corporate income he must pay tax at ordinary income rates, notwithstanding any special features the income may have had to the corporation. Thus, while income from municipal bonds owned by the corporation does not increase the corporation's taxable income, it does increase the corporation's accumulated earnings and profits and it will be taxable to the shareholders upon distribution. However, special provisions allow each shareholder to treat his pro rata share of the corporation's net long term capital gain over net short term capital loss as personal long term capital gain, up to, but not exceeding the corporation's taxable income. Thus the long term capital gain allowable is reduced by any net loss from other sources. This favorable provision may lead shareholders to elect to be taxed under its provisions for years in which they anticipate large long term capital gain.

As might be expected, previously taxed undistributed taxable

72. Through the use of "fringe benefits" a corporation may defer recognition of a portion of the employee's income. See I.R.C. § 106 (employer contributions to accident and health plans); I.R.C. §§ 401–04 (pension and profit-sharing plans). Often the corporation may be able to make tax-free payments to the employee or his survivors. See I.R.C. § 101(b) (employee death benefits); I.R.C. § 104 (compensation for injuries or sickness).
73. Section 1361(d) of Subchapter R which allows certain partnerships to be taxed as corporations does expressly exclude employee owners from the benefits of § 401(a) (employee pension trusts).
75. I.R.C. § 1375(a)(1).
76. See I.R.C. § 61(3). As taxable income consists of gains from the sale or exchange of property and taxable gains from other sources, taxable income can be less than long term capital gain only if there is a net recognizable loss from other sources.
income does not become part of the accumulated earnings and profits of the corporation, and therefore it is tax free to the shareholder upon distribution.\textsuperscript{77} A problem arises, however, as to when previously taxed undistributed taxable income may be distributed. The proposed regulations make it clear that a cash distribution\textsuperscript{78} in excess of current earnings and profits is tax free to the shareholder to the extent that he included in his income for earlier years previously taxed undistributed taxable income of the current election.\textsuperscript{79} Although this distribution will be tax free regardless of the presence of accumulated earnings, there can be no tax free distribution prior to total distribution of accumulated earnings unless total current earnings and profits have been distributed in cash.\textsuperscript{80}

However, the right to receive a tax free distribution out of previously taxed undistributed income when the corporation has accumulated earnings is personal to the shareholder who (a) paid the previous tax (b) during the current election.\textsuperscript{81} Therefore, upon transfer of the shareholder’s stock\textsuperscript{82} or upon termination of the election previously taxed undistributed income becomes a part of the capital of the corporation,\textsuperscript{83} and cannot be distributed before accumulated earnings.

To avoid the problem of termination or transfer of stock before previously taxed “undistributed taxable income” has been completely distributed, it has been suggested that net taxable income for each election year should be predicted before the end of the taxable year and paid out as money dividends.\textsuperscript{84} If the earnings are

\textsuperscript{77} I.R.C. § 1377(a). The portion of undistributed taxable income upon which tax has been paid is treated as a reinvestment, and consequently the shareholder’s basis of stock is increased by this amount when he pays the tax. I.R.C. § 1376(a).


\textsuperscript{79} I.R.C. § 1375(d)(2); Proposed Treas. Reg. § 1.1375–4, 24 Fed. Reg. 1802 (1959). The amount which may be so distributed is reduced by the amount allowed to the shareholder as a net operating loss in prior years in which the current election was effective. I.R.C. § 1375(d)(2)(B)(i).

\textsuperscript{80} As noted in the proposed treasury regulations, this is a local result of two rules formulated in the regulations; (1) when property and cash distributions are made, current earnings and profits are first allocated to the cash distributions, Proposed Treas. Reg. § 1.1373–1(d), 24 Fed. Reg. 1799 (1959), and (2) undistributed taxable income can only be distributed in cash, Proposed Treas. Reg. § 1.1375–4(b), 24 Fed. Reg. 1802 (1959).


\textsuperscript{82} This apparently includes transfers by sale, devise or gift.

\textsuperscript{83} As previously taxed undistributed taxable income is not part of accumulated earnings, I.R.C. § 1377(a), termination must cause it to become an addition to capital.

needed in the business, they can be lent back. The danger in this scheme lies in the possibility of termination after the dividend but before the end of the taxable year or determination after the close of the taxable year that the corporation was not a Subchapter S small business. In that event, the corporation will pay corporate income tax upon total taxable income of that year, and in addition the shareholders will pay personal income tax upon total earnings and profits even though much of those earnings may be reinvested. Another danger is the possibility of over-estimating the earnings, thus forcing the stockholders to pay personal income tax on an unintended distribution of accumulated earnings which were, for all practical purposes, a part of permanent capital.

Related to the foregoing income tax considerations under Subchapter S, is the problem of determining how the losses of the electing corporation will be treated. Although a net operating loss incurred during an election year cannot be deducted from the electing corporation’s income, a shareholder can deduct his pro rata share of such a loss directly from his gross income and can treat any excess as an operating loss carryover.

The shareholder’s net operating loss deduction first reduces the basis of his stock until that basis is exhausted, and then reduces the basis of any debt owed to him by the corporation. Of course, since neither basis can be negative, operating loss is deductible only to the extent of the shareholder’s basis of stock and debt as of the last day of the taxable year, or, if he sells his stock during the year, on the day of sale. Shareholders whose basis is less than their expected share in operating loss may take advantage of the loss by lending money to the corporation before the close of the taxable year. The shareholder would then obtain an operating loss deduction for the cost of an equal amount of capital gain in the repayment year.

The pro rata share of loss of each stockholder is calculated by a per day allocation, and is allowed to any person who held shares during the year. Thus, while the corporation on a fiscal taxable year may manipulate income between the calendar taxable years of its shareholders by the use of dividends, loss is evenly distributed throughout the year. This provision eliminates the possibility of

85. See note 71 supra.
86. I.R.C. § 1374(b).
87. Under § 1374(d)(1) the operating loss deduction is considered a loss from trade or business of the shareholder. Therefore, the loss may be carried back or carried over under § 172 without the limitation imposed by subsection 172(d)(4). However, the loss cannot be carried back to years beginning before January 1, 1958. I.R.C. § 1374(d)(2).
88. I.R.C. § 1376(b).
89. I.R.C. § 1374(c)(2).
90. I.R.C. § 1374(c)(1).
shifting of loss among taxpayers before the end of the corporate year.\(^9\)

(3) Business advantages

Although an electing corporation may obtain all local law corporate business advantages, certain problems are created by the qualifying and terminating features of the subchapter provisions themselves.

A. Continuity

While the electing corporation's life is continuous, its status as an organization free from federal income tax is uncertain. Some terminating events cannot effectively be predicted or precluded from occurring. Therefore, there is always a chance of an unexpected termination by law in the middle of a taxable year, and if an organization selects the corporate form, relying upon Subchapter S to avoid corporate taxation, termination of the election may dictate immediate reorganization in an unincorporated form.

B. Transferable interest

Though the electing corporation, like any other corporation, may make its stock freely transferable, the owners will find it desirable to place conditions on alienability. The election will terminate if any of the Subchapter S restrictions on stock ownership are violated.\(^9\) Furthermore, the requirement of consent of all new stockholders\(^9\) places the minority stockholder in a strong position to force the majority stockholders to purchase his stock at a price higher than its reasonable value, to force high dividends, or to adopt a minority policy view. But even assuming the good faith of all stockholders, this requirement still presents dangers because the individual purchasing interests in the corporation may have good business reasons for refusing to consent to the election. Suppose, for example, that the corporation retains much of its earnings for the expansion of its assets. A new shareholder's outside income may be so low or so high that he cannot pay or will not profit from paying individual tax on the earnings retained, and will therefore prefer to pay taxes only on dividends actually distributed.\(^9\)

92. I.R.C. § 1372(d)(3).
93. See note 57 supra.
94. Suppose the new shareholder had no outside income and his estimated share in corporate earnings is $10,000 of which only $2,500 is to be distributed.
A possible method of protecting the election against such terminations is a requirement that stock cannot be sold before first being offered for sale to the individual stockholders or the corporation. This type of agreement is probably valid and enforceable. The utility of the "first offer" agreement, however, is limited by the necessity of obtaining funds to purchase a large interest and also the problem of determining an agreeable, pre-arranged pricing device. A more workable method may be a condition on the sale of stock allowing transfers only to individuals who, prior to transfer, agree to the election. Further transfer should be allowed only when the whole interest is conveyed to one individual who is a resident or a citizen. If shares are transferred as community property, or to several people individually, as joint tenants, tenants in common, or tenants by the entireties, the ten shareholder requirement may be violated.

The drawback in directly restricting the transferability of the shares by imposing conditions on their sale is the possibility that the conditions will be held invalid. However, since courts generally uphold such conditions in closely held corporations if the conditions do not prohibit sale and tend to promote better and more unified management, conditions on an electing corporation's stock designed to protect an election may well be deemed valid.

C. Centralized management

Although Subchapter S provides that a corporation cannot qualify for the election if it has more than one class of stock, the Subchapter does not designate the distinguishing features that will create separate classes of stock. However, the proposed regulations provide that any difference in the voting, distribution or dividend rights will create two classes of stock. One author has suggested

Assuming his adjusted gross income to be $8,400, he is left with $314 of disposable income. On the other hand, if his outside income were $50,000, he would have a reduction of net income after taxes of $5,000. See I.R.C. § 1(a).

96. See generally, O'Neal, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 Harv. L. Rev. 773 (1952). The restriction must also comply with the Uniform Stock Transfer Act § 15 (adopted in all 50 states and the District of Columbia, 6 U.L.A. 6 (Supp. 1958)). Section 15 states: "[T]here shall be no restriction upon the transfer of shares so represented [by a written certificate] by virtue of any by-laws of such corporation, or otherwise, unless the right of the corporation to such lien or the restriction is stated upon the certificate."
98. See Model Clothing House v. Dickinson, 146 Minn. 367, 371-72, 178 N.W. 957, 959 (1920).
debt financing as a means of circumventing the "one-class" requirement,^{100} but the proposed regulations make it clear that such an attempt will be very carefully scrutinized.^{101} Because of the rigid interpretation given this requirement by the proposed regulations, it will probably be impossible for a promoter to obtain non-representative management control of an electing corporation.^{102}

**Conclusion Part I**

While the limited partnership and the electing corporation both possess many corporate business advantages without incurring corporate taxation, there exist some important differences in the business advantages obtainable under each form. For this reason the decision between the two forms should be individually made to tailor the organization to meet the desires of the particular associates.

The greatest difference, which also will often be the most important consideration to the investors, is the centralization of management control. If all investors wish to have a voice in selecting the management, the limited partnership is unacceptable, while if one or several of the investors demand unfettered control of management, the electing corporation, which must consist entirely of stock with equal voting rights, is equally unacceptable. Differences of a lesser degree also exist in each of the other corporate advantages previously discussed.

If all investors desire limited liability the limited partnership will not satisfy their needs, for under this form at least one investor must be willing to assume both unlimited liability and management responsibility. On the other hand, if one investor demands both a voice in management and limited liability, the limited partnership is similarly unsuitable. In these situations the electing corporation would satisfy all requirements, since each member would have limited liability without sacrificing his voice in management. However, limited liability of all members would be ef-

---

101. See note 99 supra.
102. Possibly some subtle differences in voting power may exist without violation of the "one class of stock" requirement. For example, in accordance with the Technical Information Release of November 28, 1958, a corporation with class A and class B stock each voting for one-half of the members of the board of directors does not violate the one class of stock requirement. Upon this ruling, the promoter owning all stock in class A could retain one-half voting control regardless of the relative number or value of his stock. However, the Proposed Regulations state that the one class of stock requirement will be violated in this situation unless "each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group." Proposed Treas. Reg. § 1.1371-1(g), 24 Fed. Reg. 1794 (1959).
fectively obtained in the limited partnership if the general partners were men with little personal wealth. But according to the dicta in the *Glensder* case such an organization would be an association taxable as a corporation.

In undertakings which require a large capital investment over a long period, continuity of the organization will often be essential, for the power in an investor or his representative to demand the return of his capital investment upon the happening of an unpredictable event may force the untimely liquidation of essential assets. For such undertakings, the organization must possess the flexibility of an electing corporation to replace a managing member upon his death, incapacity or retirement without disrupting the business operation. Although the problem could be partially cured through the use of partnership insurance and installment buy-out agreements, the limited partnership may still be inadvisable in such undertakings, especially since the difficulty and expense of such curative measures is avoided by the use of the electing corporation form. However, in undertakings of short duration or those which require only a small capital investment, the conditional continuity of the limited partnership may adequately satisfy investor requirements.

Finally there is some difference in the transferability of stock in an electing corporation and an interest in a limited partnership. The transferor of a limited partner's interest may convey all his rights and interests, while the transferee of stock in an electing corporation cannot convey the valuable right to receive tax free distributions from undistributed taxed income prior to the distribution of accumulated earnings. The loss of this right will be borne by the transferor, and consequently will discourage transfer in businesses which have accumulated earnings. On the other hand, the common unfamiliarity with the limited partnership form may hamper the sale of the limited partnership interest.

II. FAMILY INCOME SPLITTING

Dividing the income from a family business among the members of the family spending unit may reduce the family's total tax burden without reducing its income. However, since a basic principle of federal income taxation requires that income be taxed to the person who actually earns it, income may be shifted to family members for tax purposes only to the extent of the value of services they render to the business, and the profits attributable to their capital interests in the business.103 If one or more family members

---

do not or cannot render services to the business, income can still be successfully shifted in many cases by transferring capital interests to them. This section will examine the requirements which must be satisfied to successfully transfer a capital interest to family members, for tax purposes, both in a limited partnership and in an electing corporation.

A. Limited partnership

In order to successfully shift partnership income by transferring a capital interest to another member of the taxpayer's family, (1) capital must be a factor in the production of the partnership's income and (2) the grantor must constitute the grantee a partner for tax purposes. Although a business purpose for forming a partnership is no longer required, the parties must have a good faith intention to form a partnership with each other; that is, there must be more than a sham transaction or the grantee will not be constituted a partner for tax purposes. Several formal steps will be some evidence of the necessary good faith intention, and these should carefully be followed; for example, there should be a formal partnership agreement, and public attention should be called to the fact of partnership by giving notice to those who had dealt with the old management.

104. For example, the family partnership involved in Parker v. Westover, 144 F. Supp. 933 (S.D. Cal. 1956), included partners whose ages were 14, 11, 6 and 3. Certainly they could give no vital service to the partnership.


107. Commissioner v. Culbertson, 337 U.S. 733 (1949), was interpreted by many lower courts as holding that family partnerships could be valid for tax purposes only if they were created for a business purpose other than tax reduction. See, e.g., Slifka v. Commissioner, 182 F.2d 345 (2d Cir. 1950). However, two years subsequent to the Culbertson decision, Congress enacted a provision, now § 704(e) of the 1954 Code, which requires tax recognition of partners who own a capital interest in a partnership regardless of the reason for the creation of the partnership. The Senate committee report states that the committee believed this to be the proper interpretation of the Culbertson decision. S. Rep. No. 781, 82nd Cong., 1st Sess. 40 (1951). Although the Code provision is applicable only to taxable years beginning subsequent to 1950 and has not yet been applied by the courts, many cases decided subsequent to the enactment of the family partnership provision have recognized a partner for tax purposes without requiring a business purpose. See, e.g., Henslee v. Whitson, 200 F.2d 538 (6th Cir. 1953); Drechsler v. United States, 161 F. Supp. 319 (S.D.N.Y. 1958); contra, Maxwell v. Commissioner, 208 F.2d 542 (4th Cir. 1953).


109. Sidney Cohen, 27 T.C. 221 (1956); Mary Frances Lewis, 23 T.C. 538 (1954). The absence of a formal agreement was regarded as some evidence that the parties did not intend to form a partnership in Stoffield v. Commissioner, 203 F.2d 667 (7th Cir. 1953).

portant factor in determining whether the grantee is in fact a partner is actual transfer of control over the partnership interest. Thus the two factors in family partnership cases are the control given up by the grantor and the importance of capital in the production of the partnership income.

(1) Control given up by the grantor

To constitute the grantee a partner, the grantor must transfer the rights and duties incident to the partnership interest which by the agreement he expressly purports to convey. To transfer a general partner's interest, the grantee must be given the right to take an active part in the management of the business. But the grantor will generally prefer to convey a limited partnership interest, in order to retain full management control.

If the grantee is a minor unable to exercise dominion and control over a limited partner's interest it could be held in trust for his benefit. A third-party trustee will be recognized as a valid partner unless he is under the control of the grantor. However, such a trustee with necessarily broad powers may be able to assign his partnership interest or refuse to reinvest the earnings in the partnership; and the inclusion of the trustee within the partnership would to this extent be undesirable. Recently, some courts have allowed partnerships to restrict the trustee's power over disposition of the capital interest transferred, but any restriction on the right to receive a full share of earnings will be strong evidence that the parties did not intend in good faith to form in a partnership. For this reason the grantor may desire to constitute him-

111. MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.10, at 41 (1957).
114. For examples of cases upholding family limited partnerships without participation in management by the limited partners, see Greenberger v. Commissioner, 177 F.2d 990 (7th Cir. 1949); Thomas H. Brodhead, 18 T.C. 726 (1952); Theodore D. Stern, 15 T.C. 521 (1950); see Treas. Reg. 1.704-1(e)(2)(ix) (1956); but see Roughan v. Commissioner, 198 F. 2d 253 (4th Cir. 1952).
115. See Mary Frances Lewis, 23 T.C. 538, 548 (1954).
116. Louis R. Eisenmann, 17 T.C. 1426 (1952); Treas. Reg. 1.704-1(e)(2) (vii) (1956). Conversely, in Fred M. Harvey, 21 T.C. 1020 (1954), the family partnership was held invalid because the trustee-partner was an employee of the partnership and not acting in an independent manner.
117. E.g., Leon Fainbatt, 27 T.C. 969 (1957) (grantor restricted sale of limited partner's interest without consent of all members); Thomas H. Brodhead, 18 T.C. 728, 729, 734 (1952) (trustee of capital was required to purchase limited partner's interest and could not assign without the consent of the general partner). S. REP. No. 781, 82d Cong., 1st Sess. 40 (1951) states: "Not every restriction upon the complete and unfrettered control of the donee of the property will be indicative of sham in the transaction." (Emphasis added.)
118. Treas. Reg. § 1.704-1(e)(1)(viii) (1956); See Boyt v. Commissioner,
self trustee. If the grantor does this he can, as a practical matter, transfer a general partner's interest without losing management control. However, it would be very difficult to prove that he is acting independently as trustee, segregating the management rights of the trust from his personal management interest. On the other hand, he can more easily show independent action as trustee of a limited partner's interest by segregating the trust funds from his personal funds. The most serious danger of not having an independent trustee, however, is that the grantor-trustee may not fully understand the importance of rigorous allegiance to the formalities of separating the funds, or he may be tempted to invade the corpus occasionally for his own use.

(2) Capital as an income producing factor

If the partnership earnings are solely the result of the grantor's efforts, any transfer of a "partnership interest" is logically a mere assignment of his income, and accordingly the Code and Treasury Regulations recognize the grantee as a partner only if capital is a material income-producing factor in the business. Recently courts have been more liberal; in Greenberger v. Commissioner, though the partnership income was earned by commissions on sales and capital was not a material factor of income production, the court upheld the family partnership on the finding of a good faith intention to share profits. The Greenberger case was recently followed in Leeb v. Jarecke, which held a family partnership valid even though the annual earnings of the partnership were as high as 670% of the capital investment. The court expressly denied that a family partnership could be created only when capital was essential to the business, and held it sufficient that some capital was "necessary to the formation and continuance of the business." Although, both Congress's "material income producing factor" and the courts' "of some importance" tests are subjective,

209 F.2d 833 (8th Cir. 1954); Joe Lynch, 20 T.C. 1052, 1066 (1953), rev'd on other grounds, 216 F.2d 574 (7th Cir. 1954); William D. West, 19 T.C. 808 (1953); Russell Giffen, 14 T.C. 1273 (1950).


120. See, e.g., Theodore D. Stern, 15 T.C. 521 (1950).


122. I.R.C. § 704(e).


124. 77 F.2d 990 (7th Cir. 1949).

125. 156 F. Supp. 6 (N.D. Ill. 1957). As this decision determined the validity of a family limited partnership during years prior to the effective date of section 704(e), the section was not applicable. However, the court indicated a similar decision would have been reached had section 704(e) been applicable. Id. at 10.

126. 156 F. Supp. 6, 9 (N.D. Ill. 1957).
the difference in degree is apparent. Certainly capital is not a material income-producing factor when the business returns capital at the rate of once every two months, but it may be of some importance in maintaining the business. Therefore, unless future cases adopt the congressional view, family income can be split by gift of capital interest in most businesses which do not derive their income solely from personal services.127 Because of the Commissioner's difficulty in establishing the invalidity of family partnerships upon the ground that capital was not a material income producing factor, he may rather in the future attempt to adjust the earnings of the partners for tax purposes to more adequately reflect the value of each partner's services.128

(B) Income splitting through electing family corporations

Insofar as a family partnership avoids the double taxation of distributions to family members who are not employees of the business, it is superior to the nonelecting family corporation as an income splitting device. However, since the family corporation which elects under Subchapter S avoids the double taxation of dividends, it may offer equal, if not better, opportunities for family income splitting.

The elements of a valid transfer of stock for tax purposes are similar to those of a valid transfer of a limited partnership interest: to shift the incidence of taxation upon future earnings of stock, earnings must be attributable to capital ownership129 and the donor must irrevocably invest the donee with all the rights of a shareholder of the class of stock conveyed.130

However, a unique problem is presented by the use of the electing corporation as a family income splitting device. Trustees cannot be shareholders of an electing corporation, since the corporation will not qualify as a "small business corporation" if it has "as a shareholder a person, (other than an estate) who is not an individual."131 However, without the use of a trustee, it would be very difficult to prove that a minor grantee exercises dominion and control over the property and earnings by assuming a shareholder's rights and duties, since in an electing corporation these must in-

127. See I.R.C. § 704(e)(2).
128. See I.R.C. § 704(e); Lifton, The Family Partnership: Here We Go Again, 7 Tax L. Rev. 461, 468-71 (1952).
130. For example, nonvoting stock may be transferred to family members, thereby effecting the transfer of income without loss of control. See P. O'B. Montgomery, 1 T.C. 1000 (1943), aff'd, 144 F.2d 313 (5th Cir. 1944).
clude the right to vote and receive dividends for his personal use.\textsuperscript{132} Thus, the grantor must transfer stock directly to the minor\textsuperscript{133} and appoint a guardian\textsuperscript{134} or a custodian\textsuperscript{135} to exercise dominion and control for him.

If the grantor has an independent guardian appointed, transfer of the stock transfer will be recognized for tax purposes,\textsuperscript{136} but the grantor will have lost the voting rights of the transferred stock. If the grantor himself becomes the child's guardian or custodian he can, of course, retain voting control of the stock until the minor reaches majority; however, since the voting rights of the shareholder in an electing corporation are analogous to the management rights of a partner, it would be difficult to show that the grantor-guardian exercised his personal voting rights independently of his voting rights as guardian.\textsuperscript{137} For this reason an independent guardian may be necessary. Therefore, if the grantor wants to retain voting control over the interest he conveys, he may have to use the limited partnership form.

If, however, the grantor is willing to lose voting control of the transferred stock, but wants to insure that the profits of the business will be reinvested, he may prefer the electing corporation to the limited partnership; although the earnings of an electing corporation are taxed as if they had been totally distributed,\textsuperscript{138} the grantor need not divest himself of dominion and control over total earnings, but only over those earnings declared by the corporation to be distributable as dividends.\textsuperscript{139} The grantor who retains management control (by retaining at least fifty-one percent of the stock) over the distributions of earnings, retains the discretionary power

\begin{footnotes}
\textsuperscript{132} See Couldman v. Commissioner, 165 F.2d 686 (4th Cir. 1948) (stock voted by grantor); Sewell v. United States, 109 Ct. Cl. 623, 73 F. Supp. 957 (1947) (grantor was never informed of meetings and never voted); but see Lawton v. Commissioner, 164 F.2d 380 (6th Cir. 1947).
\textsuperscript{133} Minors are competent to receive stock. Ralph R. Anderson, 5 T.C. 443 (1945) (dictum); Edward H. Heller, 41 B.T.A. 1020 (1940).
\textsuperscript{134} For a typical statute governing guardians see Minn. Stat. §§ 525.45– .612 (1953).
\textsuperscript{135} Under the Uniform Gifts to Minors Act (adopted in 30 states, 9b U.L.A. 16 (Supp. 1958)), the donor may appoint himself or a third person as "custodian" for the gift. Custodians have broad powers to sell, exchange, invest and reinvest the custodial property, as well as to exercise the voting rights of the minor. Uniform Gifts to Minors Act § 4. The portion of income earned by the stock which is not used to discharge a legal obligation of support owed to the minor, is includible in the minor's gross income. Rev. Rul. 55–484, 1956–2 Cum. Bull. 23. See generally Schlesinger, \textit{When and How To Use the New Statutory Custodian for Gifts to Minors}, 5 J. Taxation 263 (1956).
\textsuperscript{137} See note 119 supra.
\textsuperscript{138} See I.R.C. § 1872.
\textsuperscript{139} See, e.g., Montgomery v. Thomas, 146 F.2d 76, 77 (5th Cir. 1944).
\end{footnotes}
to reinvest earnings. On the other hand, if the grantor of a limited partnership interest retains discretion to reinvest earnings, he has created strong evidence that he did not intend to form a partnership.\(^{140}\)

The Commissioner may adjust the income of family members to adequately reflect the value of services rendered by the grantor either to a limited partnership\(^{141}\) or to an electing corporation.\(^{142}\) However, he may reallocate income of an electing corporation only among those family members who are shareholders in the corporation.\(^{143}\) Thus, by transferring all of his stock, the grantor in an electing corporation may be able to transfer the total earnings of the business to family members. This, of course, is an advantage only if the grantor is willing to lose complete control of the corporation, and has much outside income.

III. ORGANIZATIONS UNABLE TO INCORPORATE

As a result of local law and professional codes of ethics, many firms of doctors, lawyers, stock brokers and other practicing professionals are unable to incorporate.\(^{144}\) However, Subchapter S may nevertheless offer such firms tax savings which were previously unavailable. As members of an organization classified as a partnership for tax purposes, the professionals cannot obtain tax savings from employee fringe benefits.\(^{145}\) However, in \textit{United States v. Kintner},\(^{146}\) a group of practicing physicians did obtain employee fringe benefits by intentionally organizing with sufficient corporate similarity to cause the business to be classified as a corporation for tax purposes. Although the \textit{Kintner} organization involved only fringe benefit deductions, an election under Subchapter S, if available, would of course relieve the firm of corporate taxes. Since the Subchapter S election is nowhere explicitly limited to organizations which have actually incorporated, it is apparently available to unincorporated “associations.” However, it must be stressed that this is a purely analytical result, which courts might hesitate to accept without positive showing that Congress intended Subchapter S to be available to unincorporated associations.

\(^{140}\) See cases cited in note 118 \textit{supra}.
\(^{141}\) I.R.C. § 704(e)(2).
\(^{142}\) I.R.C. § 1375(c).
\(^{143}\) \textit{Ibid.} On the other hand § 704(e)(2) requires the allocation of income of the donor and donee to reflect services rendered by the donor regardless of whether the donor is a partner in the business.
\(^{144}\) See, e.g., MINN. STAT. § 481.02 (1953) (precluding attorneys from incorporating or corporations from selling legal services).
\(^{145}\) Rev. Rul 57-163, 57-1 CUM. BULL. 128, 134.
\(^{146}\) 216 F.2d 418 (9th Cir. 1954).
Though a valid limited partnership may be a corporation for tax purposes, most limited partnership statutes require that the partnership consist of at least one general, managing partner and one limited, non-managing partner. Since managing and non-managing interests quite clearly constitute two classes of stock\textsuperscript{147} for purposes of Subchapter S, a limited partnership generally cannot elect under Subchapter S. Therefore, if associations are allowed to elect under Subchapter S and thereby obtain corporate tax fringe benefits, professional organizations may wish to organize in another form, for the “Small Business Association.”\textsuperscript{148}

**CONCLUSION**

Although Subchapter S is a more desirable business form in many circumstances than the limited partnership, it should not be arbitrarily preferred by every small business. Depending upon the circumstances and desires of the associates, one form will be more desirable than the other. This Note has presented many of the criteria by which a counselor may be guided in making the choice for his clients.

\textsuperscript{147} “The term ‘stock’ includes shares in an association . . .” I.R.C. § 7701(7).

\textsuperscript{148} The organization must meet the requirements of both the definition of “small business corporation” contained in § 1371 of Subchapter S and the definition of “association” contained in Morrissey.