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Subchapter S: The Use of Multiple Corporations to Satisfy Section 1371(a)(1): Revenue Ruling 77-220, 1977-1 C.B. 263

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Note

Subchapter S: The Use Of Multiple Corporations To Satisfy Section 1371(a)(1)

Revenue Ruling 77-220, 1977-1 C.B. 263.

I. INTRODUCTION

Perhaps no legal entity is more widely used to meet the needs of business and investors than the corporation. However, since dividend distributions do not reduce the corporation's taxable income, yet constitute income to the recipient shareholders,[1] corporate earnings may be taxed twice. While this double taxation may be avoided through stockholder salaries and valid leasing arrangements,[2] the underlying deduction for the corporate expenditure remains subject to uncertainty.[3] On the other hand, an effective Subchapter S election provides a method of assuring that corporate earnings will be taxed only once.

Essentially, the Subchapter S provisions permit the corporate entity to escape taxation altogether.[4] Instead, a proportionate share of undistributed taxable income, calculated at the corporate level, is "passed through" to the stockholders for recognition as

1. To the extent that cash distributions to stockholders come from post-1913 earnings and profits, I.R.C. § 301(c)(1) requires that the amount be included in the stockholders' gross income. Cash distributions not made from earnings and profits reduce the basis of the stockholders' stock to zero, and any excess is recognized as capital gain. I.R.C. § 301(c)(2)-(3).
2. In both instances, the corporation's expenditure reduces taxable income, thus alleviating the tax at the corporate level.
3. The corporation is entitled to deduct only a reasonable amount as salary expenses, regardless of the amount actually paid. I.R.C. § 162(a)(1). A leasing arrangement will be recognized only to the extent that the terms and conditions approximate those which would have been reached by unrelated taxpayers in an arm's length transaction. I.R.C. § 482. Alternatively, a lease of property may be characterized by the service as a sale, especially where the lessee has the option to purchase the property at a price significantly less than fair market value. In such instances, the lessee's deduction for rent would be disallowed, and the payments would be regarded as the purchase price which would be recovered through depreciation.
4. I.R.C. § 1372(b)(1).

their personal income, regardless of whether the earnings are actually distributed.[5] In addition, net operating losses are "passed through" so that they are deductible on a pro-rata basis by the stockholders to the extent of their basis in the corporation's equity and debt.[6] Appropriate adjustments in the basis of the stockholders' investment are made to reflect the recognition of income or loss.[7]

Congress has substantially limited the use of Subchapter S corporations. To qualify as the requisite "small business corporation," the entity must be a domestic corporation[8] which is not a member of an affiliated group.[9] Except in limited circumstances, the corporation cannot have more than ten stockholders,[10] and in

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5. *See* I.R.C. § 1373.
6. I.R.C. § 1374(a). The use of long term debt in a Subchapter S corporation is hazardous because of the possibility that it will be regarded as a second class of stock in violation of the "one class of stock" requirement of I.R.C. § 1371(a)(4). Such a classification of the debt would result in invalidation, retroactive to the time the loans were made, and assessment of a corresponding corporate tax deficiency. The regulations provide a safe-harbor for the use of debt in a Subchapter S corporation. The debt will not be regarded as a second class of stock if the "purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock. . . ." Treas. Reg. § 1.1371-1(g), T.D. 6432, 12-18-59, *as amended by* T.D. 6667, 7-29-63; T.D. 6904, 12-17-66; *and* T.D. 6960, 6-24-68.
7. I.R.C. § 1376. The basis of a stockholder's stock (but not debt) is increased by the amount of undistributed corporate income which is taxed, and decreased by the proportionate share of net operating losses, but not below zero. Once the basis in the stock is reduced to zero, the stockholder's basis in debt is reduced.
8. I.R.C. § 1371(a).
9. The definition of "affiliated group" contained in I.R.C. § 1504(a) is used for Subchapter S purposes. Interestingly, a domestic corporation electing Subchapter S status may have foreign subsidiaries which are not considered part of the affiliated group under I.R.C. § 1504. Moreover, the electing corporation must own more than 80 percent of the subsidiary's stock in order to be considered part of an affiliated group. The special rules for Subchapter S corporations exempt from affiliated group status a subsidiary which "(1) [has] not begun business at any time on or after the date of its incorporation and before the close of the parent's taxable year, and (2) does not have the taxable income for the period included within [the parent's] taxable year" in question. I.R.C. § 1371(d).
10. I.R.C. § 1371(a)(1). The Tax Reform Act of 1976 added new subsection (e) to section 1371, which increased the existing limit to a maximum of fifteen stockholders if (1) the corporation has been an electing small business corporation for a period of five consecutive taxable years; or (2) during that five year period, the number of stockholders of an electing small business corporation increased to an amount in excess of ten (but not more than fifteen) solely by reason of additional stockholders who acquired their stock through inheritance.

no case may it have more than one class of stock.[11] Only individuals, estates and certain trusts,[12] none of which can be a non-resident alien,[13] may own stock in the electing corporation.

Revenue Ruling 77-220[14] involved an attempt to circumvent the provision which limits the number of permissible stockholders to ten. In order to elect Subchapter S, thirty persons formed three electing corporations with ten stockholders in each. To facilitate the conduct of a single business, the corporations then formed a partnership. Not surprisingly, the Internal Revenue Service recognized the "sham" nature of the transaction and treated the three entities as a single corporation for the purpose of the Subchapter S election. The result was that the stockholder limitation was exceeded, thereby invalidating the Subchapter S elections. The purpose of this note is to examine the statutory restriction of the number of stockholders and the methods by which it can be satisfied. Consideration is given to techniques to "shrink" the number of stockholders, with particular emphasis on the effect of Revenue Ruling 77-220.

II. ELIGIBILITY TO ELECT SUBCHAPTER S: SECTION 1371(a)(1)[15]

It is clear that Congress intended Subchapter S tax benefits to be available only to those businesses which are "small business corporations."[16] Since section 1371(a)(1) is the only eligibility requirement relating to the size of the corporation,[17] a reasonable inference arises that this restriction was intended to establish the boundary of a small business corporation. Due to the potential tax savings to be gained under Subchapter S, the IRS can be expected to interpret this requirement as narrowly as it has other requirements.[18]

Although the objective nature of the provision has minimized the need for interpretive decisions, resulting in very little litigation, it has provided some rather unfortunate results. In some in-

11. I.R.C. § 1371(a)(4).
12. I.R.C. § 1371(a)(2).
13. I.R.C. § 1371(a)(3).
14. 1977-1 C.B. 263.
15. I.R.C. § 1371(a)(1).
16. S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958), 1958-3 C.B. 1008; Peckron, *Subchapter S Shareholder Requirement: Need for a Change*, 55 TAXES 92, 94 (1977).
17. The number originated in a study conducted by the Treasury Department in 1947 in which it was recommended that the tax benefits be confined to corporations with ten to fifteen shareholders. *See* Suwalsky, *Subchapter S-Elections*, 178-3rd TAX MNGM'T (BNA) A-1 & n.1 (1976).
18. *See* text accompanying note 33 *infra*.

stances, it precludes the opportunity to bring a son or daughter into the business and give him or her a financial interest through equity ownership. Moreover, it imposes significant restrictions on estate planning for the stockholders of an electing corporation. Where section 1371(a)(1) would be violated, inter vivos gifts of stock intended to fit within the gift tax present interest annual exclusion, are effectively precluded. So too are testamentary transfers to family members that would result in too many stockholders. In both of these instances, the unlucky stockholder is placed in the precarious position of choosing between disharmony with family members or with fellow stockholders.[19]

Circumvention of the ten stockholder limitation has been substantially diminished by legislation prohibiting organizations with more than one member from being stockholders. For example, to avoid spreading beneficial ownership among several persons, a partnership cannot be a stockholder of an electing corporation.[20] The same rule precludes a corporation from owning stock in an electing Subchapter S corporation.[21] Additionally, in negating a seemingly reasonable approach, the Service will not permit intrafamilial attribution of stock ownership in order to reduce the number of stockholders for section 1371(a)(1).[22]

The Service considers stockholders to be "*[o]rdinarily*, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation . . . ."[23] The hedge, "ordinarily," has left the door open to define stockholders in a different way in "extraordinary" circumstances. Apparently, the Service believes the area is subject to abuse and has sought to avoid being confined to solely one approach.

The usual focus is upon beneficial rather than legal ownership. In this regard, the regulations provide that where stock is held by a nominee, agent, guardian or custodian, the beneficial owner is "generally" regarded as the owner.[24] This forecloses the opportunity to spread stock ownership among a stockholder's children in a custodial arrangement in order to reduce the number of stockholders that would result from outright ownership by the children.

Perhaps the most obvious vehicle to reduce the number of stockholders would be joint ownership by different parties. Multi-

19. *See* Pennell, *Subchapter S—The Need for Legislation*, 24 TAX LAW. 249, 260 (1971).
20. *See* I.R.C. § 1371(a)(2); Rev. Rul. 59-255, 1959-2 C.B. 192.
21. *See* I.R.C. § 1371(a)(2).
22. Rev. Rul. 59-187, 1959-1 C.B. 224.
23. Treas. Reg. § 1.1371-1(d)(1), T.D. 6432, 12-18-59, *as amended by* T.D. 6667, 7-29-63; T.D. 6904, 12-17-66; *and* T.D. 6960, 6-24-68 (emphasis added).
24. *Id.* Again, it should be noted that the Service has left an "escape" to be used where necessary to invalidate a Subchapter S election.

ple persons could take stock as tenants in common in order to be treated as a single stockholder and still preserve the right to make a testamentary disposition of their interest. The Service contemplated this device and, consistent with the focus on beneficial ownership, will count each joint owner [25] as a separate stockholder.[26] A statutory exception to this rule was created in 1959 to respect the identity of interest of the marital unit. Stock held as community property or in joint ownership by a husband and wife is regarded as owned by a single stockholder.[27] Although the regulations[28] apparently provide that if the spouses individually own stock in the corporation they are counted as separate stockholders even though they also own stock jointly, it is clear that one spouse can still own stock individually as well as jointly without being counted as an additional stockholder.[29] Thus, if spouses each own stock in a corporation, the number of stockholders can be reduced by the transfer of the interest of one (or both) into joint ownership with the other spouse.

The validity of the cited regulation was upheld in *Hicks Nurseries, Inc. v. Commissioner*,[30] in which the Court of Appeals for the Second Circuit agreed with the Service that a husband and wife individually owning stock in a corporation cannot be treated as a single stockholder solely because they transfer a nominal number of shares into joint ownership. This, of course, raises the question whether the individual ownership of a nominal number of shares by a husband and wife owning stock jointly would cause

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25. This includes all forms of joint ownership, *i.e.*, joint tenants, tenants in common, and tenants by the entirety. *Id.*
26. *Id. See* Harold C. Kean, 51 T.C. 337 (1968), *modified on other grounds*, Kean v. Commissioner, 469 F.2d 1183 (9th Cir. 1972), (upholding the beneficial ownership test).
27. I.R.C. § 1371(c). "This statutory change, dealing with a specific class of cotenants, seems to buttress the regulation's position (which, in proposed form, was promulgated before the statutory change) that each joint tenant and tenant in common is ordinarily a separate shareholder where they are not related as husband and wife." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.02, at 6-5 (3d ed. 1971).

    In the Tax Reform Act of 1976, Congress went one step further, and insured that upon the death of one of the spouses, the estate and the surviving spouse would be regarded as a single stockholder as long as the stock is held in the same proportion as it was prior to the decedent's death. Otherwise, the death of a stockholder could cause the inadvertent termination of a Subchapter S election. The same rule applies to the two estates upon the death of both spouses. I.R.C. § 1371(c)(3)-(4).
28. Treas. Reg. § 1.1371-1(d)(2), T.D. 6432, 12-18-59, *as amended by* T.D. 6667, 7-29-63; T.D. 6904, 12-17-66; *and* T.D. 6960, 6-24-68.
29. "For this purpose, if a husband or wife owns stock in a corporation individally, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder." *Id.*
30. 517 F.2d 437 (2d Cir. 1975).

them to be regarded as separate stockholders. A literal reading of the regulation would require such a result.

An interesting situation is presented if stock is owned by a trust. Again, several persons could transfer their stock to a trust in order to reduce the number of stockholders to solely the trust itself. Accordingly, Congress provided that a trust may not own stock in an electing Subchapter S corporation. Limited exceptions were carved in the Tax Reform Act of 1976.[31] Contrary to the Treasury's former position,[32] voting trusts were made permissible stockholders.[33] However, since the beneficial owners will certainly be included in determining the number of stockholders, the voting trust provides little opportunity to reduce the number of stockholders. Also granted special treatment under the Tax Reform Act were trusts in which the grantor is treated as the owner for income tax purposes.[34] In these trusts, the grantor rather than the beneficiaries recognizes income from dividend distributions with respect to the stock. Accordingly, the regulations would call for the grantor, rather than the beneficiaries, to be counted in determining the number of stockholders.[35] Thus, where the grantor transfers stock to a trust and retains a reversionary interest,[36] a power to control beneficial enjoyment,[37] a power to revoke,[38] an income interest,[39] or certain administrative powers,[40] he or she should be treated as the sole stockholder regardless of the number of beneficiaries. In this way, an increased number of persons can obtain an interest in the corporation provided the grantor literally pays for it. In response, the Service may regard this as an "extraordinary" instance in which the stockholder is not "per se" the person taxed on dividends in order to count the trust beneficiaries as stock owners.[41] Moreover, since the grantor trust is particu-

31. Pub. L. No. 94-455, § 902(c)(2)(A), 90 Stat. 1609 (1976).
32. Prior to the change, the regulations provided that a voting trust disqualified the election on the ground that the trust was a stockholder other than an individual or an estate. Treas. Reg. § 1.1371-1(d)(1), T.D. 6432, 12-18-59, *as amended by* T.D. 6667, 7-29-63; T.D. 6904, 11-27-66; *and* T.D. 6960, 6-24-68. However, the courts disagreed. *See* Lafayette Distrib., Inc. v. United States, 397 F. Supp. 719 (W.D. La. 1975); A & N Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S.D. Ohio 1967); W & W Fertilizer Corp. v. United States, 527 F.2d 621 (Ct. Cl. 1975).
33. I.R.C. § 1371(f)(2) made "[a] trust created primarily to exercise the voting power of stock transferred to it" a permissible stockholder.
34. I.R.C. § 1371(f)(1).
35. *See* text accompanying note 24 *supra*.
36. I.R.C. § 673.
37. I.R.C. § 674.
38. I.R.C. § 676.
39. I.R.C. § 677.
40. I.R.C. § 675.
41. *See* text accompanying note 24 *supra*.

larly appealing for a family-owned corporation (due to the fact that the grantor recognizes income from dividends on the stock), an attack as a "sham" transaction should not be unexpected.[42]

Revenue Ruling 76-363[43] suggested another manner in which section 1371(a) might be satisfied which had not previously been addressed by either the courts or the Service. In this ruling, the Service held that the tax benefits would not be denied (under section 269) where a separate corporation is organized for the purpose of qualifying under Subchapter S. A corporation organized in 1967 by its sole stockholder was engaged in the business of selling and distributing certain products. The corporation did not elect Subchapter S status. Occasionally, it sold and distributed certain unrelated products, mostly as a convenience to its customers. In 1973, the stockholder formed a new corporation, to handle these isolated transactions. The principle purpose for organizing the separate corporation was to secure the benefits of Subchapter S with respect to these transactions. Nonetheless, the Service validated the Subchapter S election. The obvious suggestion of Revenue Ruling 76-363 was that more than one corporation could be used to conduct a company's business and one or more of them could elect Subchapter S status. Another possibility was that separate corporations, each electing under Subchapter S, might jointly conduct a trade or business. Revenue Ruling 77-220 is directed at this possibility.

III. REVENUE RULING 77-220: THE THREAT

Cognizant of the sort of multiple entity transactions that practitioners would be considering, the Service sought to curtail the breadth of its prior ruling with Revenue Ruling 77-220. The fact that significant opportunities were perceived by the Service is reflected in the quickness with which the later ruling was issued.[44]

In Revenue Ruling 77-220, the Service hypothesized thirty unrelated individuals wishing to invest in the same new business. The individuals, for reasons not stated in the ruling, wished to obtain the benefits of a Subchapter S election. In order to qualify for the election, the thirty individuals simultaneously formed three electing corporations, each with ten stockholders. All corporations were equal in contributed capital. A partnership was formed be-

42. Intra-familial transactions are particularly suspect because of the fundamental identity of interests involved and, thus, the opportunity for manufactured tax benefits.
43. 1976-2 C.B. 90.
44. Rev. Rul. 76-363 was issued the second week in September, 1976, while Rev. Rul. 77-220 was issued the week of June 27, 1977.

tween the corporations to facilitate the joint operation of a single business.

Supporting validation of the elections would be the argument that each of the multiple corporations, the use of which was authorized in Revenue Ruling 76-363, satisfied the eligibility requirements. In response, the Service applied its traditional weapon against claims of literal statutory compliance: the "substance-over-form" principle. This theory, which permits disregard of all or a portion of a transaction, makes it clear that tax consequences will be determined by the realities of a transaction rather than the form in which it is cast.[45]

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45. Underlying the principle is the policy decision that the distortion of income through the manipulation of Code provisions should be prevented. Such manipulation occurs when a tax benefit has been secured through a transaction which lies outside of the congressional intent in enacting the appropriate Code provision but is in technical compliance. To do otherwise would work to the disadvantage of taxpayers as a whole.

The Service has successfully employed the substance-over-form principle to serve a variety of purposes: Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (attribution to the corporation of gain on a sale by stockholders); Gregory v. Helvering, 293 U.S. 465 (1935) (characterization of income claimed by the taxpayer to be capital gain as ordinary income); Knetsch v. United States, 364 U.S. 361 (1960) (denial of deductions); and Kimball-Diamond Milling Co., 14 T.C. 74 (1950) (adjustments to basis).

The very breadth of the substance-over-form principle makes clear-cut distinctions in its application difficult and, moreover, inaccurate. Although it forms the basis of so-called "tests," there is such overlap between the tests that a particular taxpayer scheme is often subject to challenge under more than one rationale. In addition, while professing to be using a stated test, the courts often apply other tests as well.

One test which stems from the substance-over-form principle is the so-called "step-transaction" doctrine. A single transaction may not be divided into separate steps to obtain an improved tax result, *see, e.g.*, Starr v. Commissioner, 82 F.2d 964 (4th Cir. 1936). Characteristic of the factual patterns is an attempt to achieve indirectly a tax result more favorable than that which would have been achieved through direct means. *See also* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (gain on a stockholder sale was charged to the corporation where it was apparent that the corporation had negotiated the sale and then distributed the property in liquidation to the stockholder for its prompt sale); Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955) (rather than an outright sale of a parcel of land which would have triggered ordinary income, the seller transferred land to a controlled corporation and sold the stock in an attempt to obtain capital gains treatment); Kimball-Diamond Milling Co., 14 T.C. 74 (1950).

Probably the most pervasive of the substance-over-form applications is the "business purpose" test. First articulated where the validity of a corporate reorganization was suspect, the doctrine has been widely applied, and can be expected to encompass virtually any business transaction. Gregory v. Helvering, 293 U.S. 465 (1935), was the case which first articulated the business purpose rule. The taxpayer, a corporation's sole stockholder, wished to obtain an asset of the corporation for her individual sale. Rather than distribute the asset as a dividend to the stockholder, the result of which would

In Revenue Ruling 77-220 the Service reasoned that "since organizing three separate corporations instead of one corporation

have been ordinary income, the corporation transferred the asset to a newly created corporation. All the stock in the new corporation was issued to the taxpayer. Three days later, the taxpayer obtained the asset in liquidation of the corporation and sold it for a profit. The taxpayer vigorously argued that since every term of the reorganization statute was technically satisfied, the transaction constituted a tax-free reorganization. The Supreme Court, conceding literal compliance with the statute, reasoned that the provisions contemplated a business or corporate purpose and, lacking such purpose, the transaction was in reality a dividend distribution followed by a sale. *Id.* at 469.

Although the Supreme Court in *Gregory* found the necessity of a business purpose in the terminology of the reorganization provisions, the lower courts have not hesitated to expand the application of the test. *See, e.g.*, Unger v. Campbell, 7 A.F.T.R.2d 547 (N.D. Tex. 1960) (sale and leaseback arrangement); Ingle Coal Corp. v. United States, 127 F. Supp. 573 (Ct. Cl. 1955) (royalty payments on mined coal); Weyl-Zuckerman & Co., 23 T.C. 841 (1955) (sale of mineral rights). While the taxpayer must overcome the presumption that the Service is correct, taxpayers have succeeded even where an incidental personal benefit was obtained by the stockholders. *See, e.g.*, Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959) (preservation of a dealership arrangement with Ford Motor Company was a sufficient business purpose even though stock received through a "spin-off" was placed as security for taxpayer's alimony payments); Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947) (transaction constituted a valid corporate reorganization even though the corporation assumed personal debts of the shareholders).

Still another application of the substance-over-form principle is found where the corporate entity is disregarded. This rule, indistinguishable from the business purpose test in some settings, carves an exception to the general rule that the individual corporate entity is to be respected for tax purposes. In the leading case, Moline Properties, Inc. v. Commissioner, 319 U.S. 436, (1943), the Supreme Court succinctly set forth the rule:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or comply with the demands of creditors or to serve the creditors personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

Id. at 438 (footnotes omitted).

In interpreting *Moline*, Judge Learned Hand reasoned that the disregard of the corporate entity is justified where the corporation fails to "engage in some industrial, commercial or other business activity besides avoiding taxation." National Investors Corp. v. Hoey, 144 F.2d 466, 468 (2d Cir. 1944). *See also* Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967) (corporation disregarded where it was a mere depository for commissions earned by the equitable owner of its shares); Hindes v. United States, 326 F.2d 150 (5th Cir. 1964) (disregard of corporation where it was a mere conduit); Shaw Constr. Co. v. Commissioner, 323 F.2d 316 (9th Cir. 1963) (corporate entities disregarded where the several corporations formed were lacking in independant business purpose).

Finally, the substance-over-form principle has been applied to deny tax benefits where the transaction clearly lies outside of the congressional intent, was for the principal purpose of being able to make the election under section 1372(a)," the three entities would be collapsed into a single corporation with thirty stockholders (*solely* for the purpose of the election). Thus, section 1371(a)(1) was violated and the Subchapter S elections were invalid. While the broad language of the ruling would seem to preclude transactions in which the principal purpose is to elect Subchapter S, the true basis for the result is significantly narrower. The scheme attempted by the taxpayers had absolutely no substance beyond that of qualifying a single business with thirty prospective owners under Subchapter S.

Thus, it cannot be doubted that the Service reached the proper conclusion. Indeed, one would be hard-pressed to conceive of a factual situation more appropriate for the application of the substance-over-form theory. Although the Service sought to restrict its earlier ruling regarding the use of multiple corporations,[46] Revenue Ruling 77-220 merely imposed a "sham transaction" limitation. As such, it told practitioners little that they should not already have known.[47]

IV. REVENUE RULING 77-220: THE OPPORTUNITY

The practitioner can employ Revenue Ruling 77-220 to help avoid the factual characteristics of a sham transaction in using multiple entities to elect Subchapter S status. This can open Subchapter S opportunities not only in the realm of investment vehicles, but also in business undertakings, especially family-owned ventures and farms, in which the prospect of a multiple number of second and third generation stockholders may threaten a Subchapter S election.

Serious consideration must be given to maintaining the autonomy of the individual corporations. So long as the corporate entity is respected, the Subchapter S elections should be valid. To this

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that is, where the transaction is a sham. In these instances, taxpayers have devised elaborate schemes to secure a tax benefit through technical compliance with a Code provision. *See* Knetsch v. United States, 364 U.S. 361 (1960) (manufactured interest deduction); Higgins v. Smith, 308 U.S. 473 (1939) (loss on sale of securities to a controlled corporation). Similarly, the Service has announced that it will challenge transactions effectuated for tax avoidance purposes on the basis of *Gregory* and *Higgins*. Rev. Rul. 60-331, 1960-2 C.B. 189.

46. Rev. Rul. 76-363, 1976-2 C.B. 90 (discussed in text accompanying note 43 *supra*).

47. Virtually no aspect of corporate tax is free from application of the sham transaction doctrine, regardless of whether a revenue ruling expressly applies the doctrine to the transaction in question. In other words, absent Rev. Rul. 77-220, the sham transaction doctrine would still be a factor to consider in planning to elect Subchapter S.

end, the different corporations could be organized so that each assumes a different role in the overall conduct of the business.[48] The different responsibilities would be clearly set forth in the partnership agreement. Alternatively, instead of a partnership, the corporations might be tied by other contractual arrangements. For example, where the division is between manufacturing and marketing functions, the use of "output" and "requirement" contracts would serve the same purpose while reinforcing the autonomy of each entity. Justification for the division of the business is found in considerations such as separation of the risks and liabilities of different aspects of the business,[49] and the creation of a local image for a multi-state business operation.[50] In this way, there exists valid non-tax reasons for the separation of the business.[51] This would be more persuasive where, unlike the situation in Revenue Ruling 77-220, there was no actual pooling of resources by the prospective stockholders. The corporations should be organized as autonomous entities without regard for equalizing the amount of contributed capital. The hurdle likely to be encountered is an argument by the Service that the corporations were organized pursuant to a pre-conceived plan for tax avoidance purposes. However, even with the presumptive correctness of the Treasury's determination, evidence of valid business reasons and independent economic risk should justify the division of the business. Where bona fide business reasons exist, the fact that the taxpayer considered the tax consequences in structuring the transaction does not, in itself, support imposition of the substance-over-form theory.[52]

48. The natural division of the business would seem to be between the manufacturing and marketing functions. Perhaps a "sharing of income" concept might be employed similar to that which authorizes a Domestic International Sales Corporation (DISC) and its supplier to share equally in sales profits under I.R.C. § 994(b)(2). Such an arrangement should withstand an attack by the IRS under I.R.C. § 482 (relating to reallocation of income and deductions between related taxpayers) since the entities would not be commonly "owned or controlled."

49. *See* Your Host, Inc., 58 T.C. 10 (1972).

50. *See* Southeastern Canteen Co. v. Commissioner, 410 F.2d 615 (6th Cir. 1969).

51. The Treasury might concede the fact that business reasons justified the division of the business, but might then assume the posture that each corporation should have had *all* the stockholders, rather than permit division of the stockholders as well as the business. The approach is more likely to succeed where there is economic substance to support the separation of the stockholders. For example, where some persons contribute depreciable property, it would seem reasonable to treat them separately in order to give the contributor the advantage of the depreciation deductions.

52. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935). In *Gregory*, the Court held that "[t]he legal right of a taxpayer to decrease the amount of what would

In Revenue Ruling 77-220, the three corporations were presumably to devote all of their efforts to the partnership. If each corporation conducted a business unrelated to the others, it would certainly buttress the autonomy of the corporations. This should be considered in drafting the agreements forming the basis of the corporations' relationship. For example, it may be deemed desirable to prohibit the corporations from dealing with competitors, but the total prohibition of business dealings with *any* other person would more closely approximate the joint conduct of a single business. The taxpayers' position would be supported where each corporation contractually had the right to conduct independent business dealings. Since merely nominal activity may be disregarded, the greater the unrelated business dealings, the greater the likelihood of success. This, of course, is limited by business exigencies.

Serious consideration should be given to the timing of the transactions. The simultaneous organization of separate corporations immediately followed by the formation of a partnership, as in Revenue Ruling 77-220, indicates absence of corporate autonomy. Various aspects of the timing element must be given close attention:

1. When should the individual corporations be organized?
2. When should the contractual relationship between the corporations be formed ?
3. When should each corporation file a Subchapter S election?

On organizing the individual corporations, the important element is the time interval between the organizations. While a longer time span would seem to favor the taxpayer, practical considerations may demand simultaneous incorporation. This is particularly true where the corporations are to perform interrelated activities. Nonetheless, consideration should be given to spreading the time interval over as long a period as practicable, and, at the least, to organizing one corporation in December and the other in the following year. In this way, different tax years are involved which would seem to supplement the bona fides of the transaction. This may not be possible where a tax-sheltered investment is being effectuated, as the shelter may require formation at year-end to preserve a front-loaded deduction.

Regardless of the timing of the incorporations, each entity should begin to conduct some business-related functions immediately upon formation rather than await the organization of the other corporations. Additionally, the bona fides of the use of the multiple corporations would be buttressed by the independent op-

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otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Id.*

eration of the separate entities prior to the formation of a contractual relationship. Again, a premium is placed on formation of the corporations toward the end of the taxable year to permit the filing of at least one tax return before the entities execute a formal agreement.

An important consideration is the various times at which the Subchapter S elections will be filed. The simultaneous filing by each corporation not only "red flags" the Service, but adversely reflects upon the validity of the transaction. The decision to elect Subchapter S should be made "independently" by each corporation, and the reasons fully documented in director and stockholder resolutions. The likelihood of a favorable result would seem enhanced if some (or all) of the corporations can delay the election until after the partnership (or contractual arrangement) has operated for at least one taxable year. While this may not be practicable when the corporations are an investment vehicle, it may be an effective way to pass through a "one shot" net operating loss incurred by a partnership with corporate partners. Generally, the taxpayers' position would seem to be improved if the Subchapter S election can be filed subsequent to the formation of the contractual arrangement. The greater the time of separation, the greater the support for the taxpayer.

The final factor is best illustrated with an example. Assume XYZ corporation has eighteen stockholders. It has been determined that the stockholders would fare better under Subchapter S, but an election would be invalid due to the ten-stockholder rule.[53] If XYZ were divided into two corporations[54] of nine stockholders each, followed by a partnership arrangement, the corporations would technically qualify under section 1371(a)(1). If the principal purpose of the division were to elect Subchapter S, then under Revenue Ruling 77-220 the election would probably be invalid. Would the result be different if valid non-tax reasons provided the impetus for the division? For example, an analogy can be drawn to the "split-off" cases decided under section 355[55] in which stockholder disharmony was found to justify separating the existing corporation in order to separate the stockholders.[56] It would seem that where the business purposes pass scrutiny under sec-

53. I.R.C. § 1371(a)(1) limits qualifying corporations to ten stockholders.
54. This may be accomplished tax-free under I.R.C. § 355.
55. I.R.C. § 355.
56. Albert W. Badanes, 39 T.C. 410, 415 (1962):

> Here . . . the principal purpose of the [division of the corporation] was to enable two businessmen, who could no longer agree between themselves as to the proper means for advancing their common business interests, to separate their interests and thereafter conduct through two corporations the businesses which they had theretofore

tion 355, the transaction cannot subsequently be characterized as a sham in order to invalidate the Subchapter S election. The Service can be expected to point out that, unlike section 355 cases, the subsequent partnership between the resulting corporations seems to work against a notion of stockholder disharmony.

Revenue Ruling 77-220 involved an extreme approach by the taxpayers. On the other extreme, the best factual situation to support the validity of the Subchapter S election of the corporate partners in a partnership would take into account all of the above factors. The ideal situation would involve the organization of separate viable corporations in different tax years without a prior pooling of capital. Each corporation would assume a different responsibility in the conduct of the business. A contractual arrangement other than a partnership would tie the corporations, but permit the conduct of independent business dealings. Finally, Subchapter S elections would be filed both before and after the execution of the contractual agreements. The more nearly a transaction can be structured to approximate this ideal, the greater should be the taxpayers' likelihood of success.

V. CONCLUSION

Insofar as Revenue Ruling 77-220 involved an obvious sham, it poses no insurmountable hurdles for the tax practitioner. Absent the ruling, basic planning principles would require that careful attention be given to preserving the autonomy of the separate corporations. With proper care, the use of multiple corporations should be a workable device to "shrink" the number of stockholders in order to satisfy section 1371 (a)(1).

This discussion demonstrates what tax analysts have known for years—reform of section 1371(a)(1) is badly needed.[57] While purporting to be a barometer of a "small business corporation," it would grant the tax benefits to a very large corporation as long as it does not have more than ten stockholders.

It has been suggested that the number of permissible stockholders be increased,[58] but the Treasury Department opposes reform on the ground that audits of Subchapter S corporations

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> conducted through the use of a single corporate entity. We believe that such purpose was a sound and valid business purpose . . . .

See Rev. Rul. 56-117, 1956-1 C.B. 180; Rev. Rul. 56-665, 1956-2 C.B. 214; Rev. Rul. 69-460, 1969-2 C.B. 51.

57. *See, e.g.*, Peckron, *supra* note 16, at 99; Pennell, *supra* note 19, at 249.

58. Peckron suggested increasing the number of permissible shareholders to thirty. Peckron, *supra* note 16, at 99. This accords with the recommendation of the American Bar Association Committee on Subchapter S Corporations. *See* 28 Tax Law. 705 (1975).

would result in increased administrative burdens. However, the IRS has managed to overcome this problem in the partnership context. The advent of computerized technology certainly helps in this regard. Moreover, what is really involved is an adjustment at the corporate level, from which the stockholders' income would correspondingly be adjusted. However, to increase the number of permissible stockholders is simply to restate the problem. The better reform would be the abandonment of the number limitation altogether in favor of a restriction on the amount of invested capital,[59] as used in section 1244.[60] This would truly limit Subchapter S benefits to small business corporations. For the present, however, practitioners should consider artful ways to satisfy section 1371(a)(1), rather than foregoing the benefits altogether.

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59. Pennell, *supra* note 19, at 260.
60. I.R.C. § 1244 authorizes an ordinary deduction on the sale or exchange of stock of a "small business corporation" at a loss. In the absence of such a provision, the taxpayer would only be entitled to capital loss treatment.