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ORGANIZING THE NEW CORPORATION —SOME TAX CONSIDERATIONS

ROBERT WEISS*

The organization of a Wisconsin corporation can be a simple matter. The Wisconsin Business Corporation Law (Chapter 180, Wisconsin Statutes) eliminates much of the traditional ritual and simplifies filing requirements to the point that the preparation of acceptable Articles of Incorporation can be a matter of filling in the proper blanks on the proper forms. But a closer analysis indicates that these are for the most part changes in mechanics only and, like an iceberg which is only one-eighth visible, it is the areas hidden below the surface which present the greatest problems and which, if not anticipated in time, can be fatal.

This article analyzes one of the troublesome areas in organizing the new corporation — taxes, outlines some of the issues which should be considered and suggests some possible solutions. As a convenient approach to the problem we will divide the corporate balance sheet into its three principal components — assets, liabilities, and capital — and to try to determine with respect to each of these: first, what we wish to accomplish taxwise, and second, how and to what extent we can achieve the desired result.

TO INCORPORATE OR NOT TO INCORPORATE

Although we are concerned here primarily with the tax problems of the new corporation, we should not overlook the fact that the initial question of whether the enterprise should be conducted in corporate form has significant tax implications. In most cases the corporation will be the most expensive form of doing business because under the Internal Revenue Code the corporate veil is something of a sieve through which taxes are extracted twice, once from the corporation as income is received or accrued and once from the shareholders as earnings are distributed as dividends.¹ Two taxes are usually more expensive than one. There are many instances, on the other hand, in which the corporation serves to reduce taxes. Corporate income is taxed at a rate of only 30 per cent on the first \$25,000 and 52 per cent in excess of \$25,000.² Consequently, in cases in which the tax brackets of the shareholders are higher than this as a result of

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¹ INT. REV. CODE OF 1954, §§301 (c) (1) and 316. All section references are to the Internal Revenue Code of 1954 unless otherwise stated. In the early stages of the corporate business the tax on dividends may be eliminated by distributing earnings to stockholder employees as salaries, but this is a rather transparent device and unreasonable salaries will eventually be disallowed and treated as dividends.

² INT. REV. CODE OF 1954, §11 (b) and (c).

income from other sources, there will be an initial saving in having the income taxed at the lower corporate rates. E.g., Assume that Dr. Money, a married taxpayer, has a taxable income of \$36,000 per year from his medical practice. He is contemplating the purchase of a building which will produce \$16,000 net income. If he takes title in his own name, the \$16,000 will be added to his other earnings and taxed in the amount of \$9,080, but if the building is operated as a corporation, the tax will be 30 per cent of \$16,000 or only \$4,080. Eventually, of course, the earnings must be distributed³ and the second tax paid, but if this is done by liquidating the corporation, the accumulated earnings will be taxed to the shareholders at capital gain rates if the corporation is not a collapsible one.⁴ The shareholder may even eliminate this capital gains tax by dying (a rather drastic tax saving scheme) before he disposes of his stock because upon death the basis of the stock is adjusted to fair market value and a subsequent sale or redemption at this figure results in no taxable gain.⁵ There are some cases involving taxpayers in extremely high brackets in which the tax to the corporation plus the capital gains tax to the shareholders upon liquidation produces less total tax expense than would have resulted had the earnings of the business been taxed directly to the shareholders. The question is one of arithmetic in each case and is best answered by simply computing the taxes under the various possibilities.⁶

Aside from the question of rates, certain other tax factors should be considered in selecting the form of enterprise. Will the organizers, as corporate employees, enjoy the tax benefits of a qualified pension or profit sharing plan, a privilege not available to the working partner or sole proprietor?⁷ Will the corporation be utilized as an estate planning tool whereby the stockholders can make inter-vivos gifts of their shares, retain control and at the same time reduce death taxes, a plan which is impractical in most unincorporated businesses? Assuming the stockholders are parents in high brackets, would they be willing to make inter-vivos gifts of stock to their children, thereby having dividends taxed at lower rates? Can restricted stock options be utilized, thereby taking advantage of Section 421? Each of these questions presents complex issues beyond the scope of this article but they may be decisive factors and should not be overlooked.

³ INT. REV. CODE OF 1954, §531 et seq. imposes a penalty tax on unreasonable accumulations of surplus but there is an exemption which was recently increased from \$60,000 to \$100,000. Sec. 535 (c) (2) as amended.

⁴ INT. REV. CODE OF 1954, §§331 and 341.

⁵ INT. REV. CODE OF 1954, §1014.

⁶ For specific examples see Garcia, *When Should a Sole Proprietor Incorporate His Business to Save Taxes?*, 35 TAXES 110 (1957).

⁷ The Jenkins - Keogh bill, if passed, will eliminate some of the present disparities in this area.

The line to be drawn between incorporated and unincorporated businesses is not as clear in tax law as it is for most other purposes and state law is not decisive. Sec. 1361 permits a proprietorship or a partnership to elect to be taxed as a corporation where the prescribed conditions are present and such an election will in some cases result in savings. On the other hand, the recently enacted Small Business Tax Revision Act of 1958 (H.R. 8381) adds a new Subchapter S, consisting of Sections 1371-1377, to the Code which permits certain corporations to elect to be taxed as partnerships. The privilege is available only to a "small business corporation" which is defined (Sec. 1371) as a domestic corporation which is not eligible to file a consolidated return with any other corporation, does not have more than ten shareholders and does not have more than one class of stock. None of the shareholders can be corporations or nonresident aliens and not more than 20 per cent of the corporate income can be personal holding company income (rents, dividends, interest, etc.). Unlike the election of a partnership to be taxed as a corporation, the election of a corporation to be taxed as a partnership can be revoked by the unanimous consent of all shareholders. Even in the absence of an election, unincorporated associations may be taxed as corporations where they have corporate attributes.^{7a}

One other point should be emphasized before leaving the subject. Although our discussion has been solely in terms of taxes, the traditional advantages and disadvantages of the corporate form of doing business are still as relevant as when we learned them in law school and may outweigh all tax considerations. Taxes should never become the tail that wags the dog.

ASSETS

It is usually to a corporation's advantage to have as high a basis as possible for its assets because (a) this reduces the amount of taxable gain on a sale of the asset, gain being the difference between amount realized and adjusted basis⁸ and (b) this increases the amount of deductible depreciation, depreciation being computed by multiplying basis times a given rate.⁹

In the case of a tax-free transfer to the corporation, there is no tax to the transferor and no increase in basis to the corporation-transferee; therefore, the corporation gets neither of the aforementioned tax benefits resulting from a step-up in basis. However, in the case of a taxable transfer, basis to the corporation-transferee is increased and the transferor is taxed on the amount of the increase. If the tax savings to the corporation resulting from the increase in basis

^{7a} INT. REV. CODE OF 1954, §7701 (a) (3); *Morrissey v. Comm.*, 296 U.S. 344 (1935).

⁸ INT. REV. CODE OF 1954, §1001 (a).

⁹ INT. REV. CODE OF 1954, §167.

are greater than the amount taxable to the transferor, there is a net overall saving in making the transaction a taxable transfer. Consider the following hypothetical example. John Dough, a taxpayer, owns machinery and equipment which he has been using in his business and which has an adjusted basis (cost less depreciation) of \$50,000 and a fair market value of \$90,000. He has decided to incorporate his business and it appears that the corporation will be in the 52 per cent bracket. If he can transfer the assets to the corporation in a transaction in which the corporation's basis will be increased to fair market value, the \$40,000 difference between fair market value and adjusted basis will be taxable to Mr. Dough as a capital gain¹⁰ and he will pay a tax thereon of \$10,000 (25% of \$40,000). However, the addition of \$40,000 to basis will be depreciated and will produce tax savings of \$20,800 for the corporation (\$40,000 written off in a 52% bracket) and there will thus be a net saving of \$10,800 (\$20,800 less \$10,000 tax paid by transferor). The reason obviously is that the increase in basis resulting from the transfer is being written off at a 52 per cent rate and taxed at only a 25 per cent rate.

The transfer of depreciated assets used in trade or business is the situation in which this principle is most frequently applied because the gain is taxed at capital gain rates under Section 1231, but there are certain other situations where a taxable incorporation will produce savings. For example, if the asset in question consists of property which has appreciated in value and which is a capital asset in the hands of the transferor but stock in trade to the corporation, the increase in basis will be taxed at capital gain rates.¹¹ Even if capital gain treatment is not available, a taxable transfer can produce some savings where the asset will be either sold or depreciated and the transferor's bracket is lower than the corporations, because the amount of increase in basis is taxed at the lower rate.

The savings may be even greater if the transferor has operating losses or capital losses in the year of incorporation because these can be offset against gain recognized in the taxable transfer.¹² The tax resulting from the transfer in such cases will be reduced or eliminated entirely. If the transferor owns securities, for example, which have declined in value it may be wise to sell in the year of incorporation, thereby converting paper losses to capital losses and reducing tax paid on the transfer.

What is often not realized is that the question is not *if* the appreciation in asset value will be taxed but *when* it will be taxed, whether at the time of transfer to the corporation or at some subse-

¹⁰ INT. REV. CODE OF 1954, §1231.

¹¹ See *Martin v. U.S.* 128 F. Supp. 576 (E.D. Ill. 1954), *affd.* 230 F. 2d 106 (7th Cir. 1956).

¹² INT. REV. CODE OF 1954, §1231; §165 (c).

quent time. Although the "tax free" route is inviting, it may not be the cheapest.

The Taxable Incorporation. Sec. 351 (a) authorizes tax-free incorporations. It provides that no gain or loss will be recognized if property is transferred to a corporation solely in exchange for stock or securities in such corporation and immediately after the exchange the transferors of the property control the corporation. "Control" is defined in Sec. 368 (c) as ownership of (1) stock possessing at least 80 per cent of the voting power and (2) at least 80 per cent of the total number of shares of all other classes of the corporate stock.

The tax-free status, if desired, is simple to attain: all the incorporator need do is to transfer his assets to the corporation in exchange for all of its capital stock. This is what happens in the organization of most closed corporations. As indicated above, however, a taxable incorporation will sometimes be more advantageous and this is one of those rare instances wherein the taxable status is more elusive. One method of creating such a status is suggested in the statute: since ownership of 80 per cent or more of the corporate stock results in a tax-free transfer, ownership of less than 80 per cent of the stock must produce a taxable transaction. Hence, if the asset is transferred to a corporation in which 21 per cent of the stock is owned by outsiders (persons other than the transferors) a taxable transfer will result, gain will be recognized and basis increased. "Transferors" are those persons contributing money as well as those contributing other property.^{12a}

The statutory language suggests another possibility. "Control" is defined to include both 80 per cent of voting stock and 80 per cent of all other classes of stock. Thus, if the corporation issues two classes of stock, voting common and non-voting preferred, the transferors can take all of the common but if they own only 79 per cent of the preferred, the statutory standard is not met and the transfer is taxable.

Removing the requisite 21 per cent from the ownership¹³ of the transferors presents a problem, but once again the statute suggests a solution. Sec. 351 (a) states that stock issued for services shall not be considered as issued in return for property, so the 21 per cent can be issued to corporate employees for services rendered. The recipient of such stock must report its value as ordinary income, however, and this puts him in the unhappy position of paying a tax without receiving any money.

^{12a} G.C.M. 24415, 1944 CUM. BULL. 219.

¹³ "Ownership" is a difficult term in tax law because of the variety of attribution rules in various Code sections. Sec. 318, Constructive Ownership of Stock, is not by its terms applicable to transactions under Sec. 351 so ownership of stock by family members, if bona fide, will presumably not affect a Sec. 351 transaction.

Partially Taxable Incorporations. Sec. 351 (b) imposes a tax in the case of a transfer to a controlled corporation where the transferors receive, in addition to stock or securities, other property or money. (The "other property or money" is referred to in tax jargon as "boot"). The transferors' gain is recognized to the extent of the fair market value of the boot and the corporation's basis for the property is stepped up by a like amount.¹⁴

Where a taxable transfer is desired and the 80 per cent rule discussed above cannot be met, a boot transaction may be a partial solution. In Revenue Ruling 56-303¹⁵ the taxpayer, a corporation operating a retail store, purchased a tract of land intending to erect a new store and a shopping center. Later it found a more desirable tract which it purchased and on which the shopping center was built. The taxpayer then formed a subsidiary corporation to which it transferred the original tract plus \$150,000 in exchange for 6000 shares of common stock and \$600,000 face value negotiable notes. The land transferred had a basis to the transferor of \$400,000 and a fair market value of \$1,000,000. The new subsidiary planned to develop the land and sell it in lots. The ruling held that the transaction was governed by Sec. 351 (b); that the transferor realized capital gain which was recognized to the extent of the boot (the notes); and that the subsidiary's basis equalled the transferor's basis plus the recognized gain. The tremendous savings in this transaction were due in large part to the fact that the \$600,000 increase in asset value was taxed as capital gain to the transferor but would not have been so taxed to the transferee because of its development and sales activity. This result, although justified by the peculiar fact situation here, is possible only infrequently in practice.

The principle problem in boot transactions is in determining whether the debt instruments constitute a "security" (not taxable) or boot (taxable). The line to be drawn lies somewhere between long-term bonds and short-term notes but, in addition to the term of the obligation, consideration must be given to "an overall evaluation of the debt."¹⁶ Short-term notes which are extended as they become due will probably not be treated as securities but this practice will aggravate the "thin" corporation problem discussed later.

Sales to the Corporation. A third method of obtaining a stepped-up basis is to bypass Sec. 351 entirely and simply sell the assets to the corporation. The difficulty with this type of transaction is that if the transferor takes back notes instead of money, the Commissioner may

¹⁴ INT. REV. CODE OF 1954, §362.

¹⁵ I.R.B. 1956-27, p. 12.

¹⁶ *Camp Wolters Enterprises, Inc v. Comm.*, 22 TC 737, *affd.* 230 F. 2d 555 (5th Cir. 1956).

argue that the purported sale is in fact a contribution to capital and neither the gain nor the increase in basis should be recognized. The most effective argument in favor of this type of transfer is that it works, or at least it has in some remarkable cases in the past.¹⁷ In *Sun Properties, Inc. v. U.S.*,¹⁸ for example, a corporation was organized and the principal stockholder deeded two lots, having a cost to him of \$400, to the new corporation. Two week later he "sold" to the corporation a warehouse building for \$125,000 payable in semi-annual installments of \$4,000. There was no down payment, no interest and no mortgage. In subsequent years when the corporation claimed depreciation based on the purchase price, the Commissioner disallowed the deductions alleging that the "sale" was a tax free contribution to capital with no step-up in basis. The District Court agreed but the Circuit Court reversed holding that a sale was a sale, that a tax avoidance motive was not fatal to an otherwise bonafide transaction and that depreciation was allowable based on the purchase price. Although this result is surprising in view of the fact situation, it points up one method of achieving the desired result.

In setting up sales to closed corporations, do not overlook Sec. 1239 which denies capital gain treatment on the transfer of depreciable property to a corporation if the transferor, his spouse, minor children or minor grandchildren own 80 per cent of the outstanding stock of the corporation-transferee. Note that unlike certain other Code sections concerned with attribution of ownership, there is no restriction on stock being owned by parents, brothers, sisters, or adult children of the transferor.

LIABILITIES

In consideration of a transfer of assets to a corporation, an investor may receive two types of corporate obligations: (a) He may receive notes, bonds, or debentures. These are called "debt", they appear in the liability section of the corporate balance sheet and the return paid on them is interest, a deductible expense. (b) He may receive shares of stock. These are called "equity", they appear in the capital section of the balance sheet and the return paid on them is called dividends, a nondeductible distribution of earnings.

It is to the advantage of both the corporation and the investor to

¹⁷ *Hollywood, Inc.* 10 TC 175 (1948), *acq.* 1948-1 CUM. BULL. 2; *Sarkes Tarzian, Inc. v. U.S.*, 140 F. Supp. 863, (S.D. Ind. 1956); *Ainslie Perrault*, 25 TC 439 (1955), *acq.*, I.R.B. 1956-23, p. 6; *W. H. Brown*, 27 TC 27 (1956); *Estate of Miller v. Comm'r.*, 239 F. 2d 729 (9th Cir. 1957), *rev'g* 24 TC 923 (1955). For review of these cases see Pennell, *Tax Planning at the Time of Incorporation*, 35 TAXES 927 (1957). In *Gunn v. Comm'r.*, 25 TC 424 (1955), *aff'd.* 244 F. 2d 408 (10th Cir. 1957); *Houck v. Hinds*, 215 F. 2d 673 (10th Cir. 1954), *aff'g* 54-1 USTC Par. 9199 (D. Okla.); and *Aqualane Shores, Inc.*, 30 TC No. 48 (1958), the sales were invalidated.

¹⁸ 220 F. 2d 171 (5th Cir. 1955).

have as much as possible of the investment classified as debt. From the standpoint of the corporation, the payment of tax deductible interest is obviously preferable to the payment of nondeductible dividends. From the standpoint of the investor, the receipt of money in repayment of a debt, a tax free return of capital, is preferable to receipt of money in redemption of stock which may be taxed as a dividend unless the hypertechnical requirements of Sec. 302 are met. (The 1954 Code favors dividend income over interest by means of the dividend exclusion and the dividend credit but these are of little monetary significance).

In the "thin" corporation cases, the Commissioner tries to show that what the parties have labeled as "debt" is really "equity" and, therefore, that payments to investors, whether periodic or in retirement of the obligation, should be reclassified and treated accordingly by both the corporate-payor and investor-payee. The term "thin" refers to the debt-to-equity ratio, a thin ratio being one with an inordinately high amount of debt in relationship to equity. E.g., a corporation with \$10,000 in debt and \$1,000 in stock (10 to 1 ratio) is more thin than one with \$5,000 in debt and \$1,000 in stock (5 to 1 ratio). The absence of a statutory basis for the doctrine and the variety of approaches adopted by the courts makes it difficult to set forth precise standards. The cases have been reviewed in a number of thorough articles¹⁹ and only the principal issues will be outlined here.

The debt-to-equity ratio is one of the principal criteria used in determining the true nature of corporate obligations. Several of the writers on this topic have noted that there is no "safe" ratio, that each case will be decided on its own facts, and this, of course, true. But there are some guides which may be helpful. A distorted ratio such as 50 to 1 (50 dollars in debt for each dollar in equity) or 35 to 1 would probably be fatal in the absence of most unusual circumstances.²⁰ In some cases substantial but not distorted ratios, such as 24 to 1 and 20 to 1, have been sustained as creating a valid indebtedness on the strength of other evidence.²¹ And both the Tax Court and the Internal Revenue Service have indicated that a 3½ to 1 ratio is not unreasonable in the absence of other debt characteristics.²² Although

¹⁹ Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830 (1956); Weyher, *Capital Structures of New Corporations*, NYU 16TH INST. ON FED. TAX. 1958.

²⁰ Sec. e.g., *Sogg v. Comm.*, 9 TCM 927 (1950), *aff'd.* 194 F. 2d 540 (6th Cir. 1952) (50 to 1); *Dobkin v. Comm.*, 15 TC 31 (1950), *aff'd. per curiam* 192 F. 2d 392 (2nd Cir. 1951) (35 to 1); *Kipsborough Realty Corp. v. Comm.*, 10 TCM 932 (1951) (1,000 to 1). In *Leach Corp.*, 30 TC No. 54 (1958), the court found a bona fide debt with a 400 to 1 ratio.

²¹ *Rowan v. U.S.*, 219 F. 2d 51 (5th Cir. 1955), *rev'g* 54-1 USTC Par. 9326; *McDermott*, 13 TC 468 (1950) (20 to 1); *Assoc. Investors*, 57-1 USTC Par. 9396 (1956) (24 to 1).

²² *Ruspyn Corp.*, 18 TC 769 (1952), *acq.* 1952-2 CB3.

these holdings seem to form a pattern, they should be compared with decisions such as *Benjamin D. Gilbert*,²³ a case involving a 2.19 to 1 ratio, where the Tax Court treated the purported debt as equity. A point sometimes overlooked is that in computing the ratio, all corporate debts, not only debts due stockholders, should be included.²⁴

In addition to mathematics, the courts will examine certain other facts in evaluating the obligations in question.²⁵ Is corporate indebtedness to stockholders in proportion to their respective equity interests? Was there a formal loan agreement evidenced by notes, corporate resolutions, etc.? Are the terms of the debt realistic with respect to interest, fixed maturity dates, and security? Are attributes of stock such as voting rights, restrictions against transfer and subordination to claims of creditors avoided? How aggressive was the creditor in enforcing payment if the loan was defaulted? In short, do the facts indicate a legitimate debtor-creditor relationship or one more akin to that of stockholder-corporation?

Finally, much depends on the attitude of the court involved, the Tax Court frequently attempting to substitute its judgment for that of the businessman in determining how much capital he should have placed at the risk of the corporation, the Fifth Circuit questioning the very principle of reliance on high debt-equity ratios as a basis for reclassifying debts²⁶ and the Second Circuit adopting a test of "substantial economic reality."²⁷

CAPITAL

As the corporation grows and prospers the stockholders face the problem of what to do with earnings which the business has accumulated. They usually cannot withdraw such earnings in the form of salaries because they are already drawing maximum salaries allowable; they do not wish to withdraw them in the form of dividends because of the double tax problems; and they cannot continue to accumulate earnings because of the prohibitions (Sec. 531 et seq.) against unreasonable accumulations. Prior to 1954 one solution to this problem was a device known as the preferred stock bailout. The corporation would capitalize the surplus by paying a dividend to holders of common stock in the form of shares of preferred stock. The receipt of such a dividend was tax free. The preferred shares so received could then be sold and the realized gain reported as capital gain despite the fact

²³ 15 TCM 688, *rev'd and remanded* by the 2d Circuit for an explanation of the Tax Court's holding, 57-2 USTC Par. 9929 (1957).

²⁴ *Dobkin*, cited in Note 20: 1st and 2nd mortgages were included in the debt portion of the ratio.

²⁵ For cases in which some of these factors are considered see pp. 288-289 of Weyher article cited in Note 19.

²⁶ *Rowan v. U.S.*, cited at Footnote 21; *Sun Properties, Inc. v. Comm.*, *supra* note 18.

²⁷ *Gilbert v. Comm.*, 57-2 USTC, Par. 9929.

that the entire transaction was the result of prior negotiations.²⁸ Subsequently, the preferred shares might be redeemed from the purchaser. Cash was thus transferred from the corporate to the shareholder pocketbook at capital gain rates.

Sec. 306 of the 1954 Code effectively precludes the use of this device. It provides that when preferred shares which were received as a stock dividend (referred to sometimes as "hot" stock) are sold or redeemed, the gain shall be taxed as ordinary income. (There are certain limited exceptions, usually of little help.) Stock issued at the time of original incorporation does not bear the "hot" stock stigma, however, and can be sold as a capital asset. The point is that the time of original issuance of stock may be the first, last and only opportunity to issue preferred shares which are not "hot".

Aside from Sec. 306, preferred stock has certain other advantages. It can be transferred by gift, either directly or in trust, to reduce the donor's taxable estate and taxable income. When contributed to charity it produces a deduction in the amount of its fair market value. It is useful in obtaining death tax money under the provisions of Sec. 303. And it accomplishes these objectives without dilution of voting control represented by common stock. Note, however, that the Small Business Tax Revision Act of 1958 (Code Sections 1371-1377) discussed earlier in this article, extends favored tax treatment to qualifying "small business corporations". Corporations with more than one class of stock are excluded from the favored class and in some cases this may outweigh the benefits to be gained from creating preferred stock.

Where the stock is to be given to a minor, the Uniform Gifts to Minors Act, recently adopted in Wisconsin,²⁹ provides a convenient vehicle. Under this Act securities given to a minor are registered in the name of an adult (who may be the donor in some cases) as "custodian" for the minor but legal title vests in minor. For income tax purposes no trust is created; therefore, the income is taxable to the minor and not to the custodian or donor.³⁰ However, the income is taxable to the parent to the extent it is used to support the child in discharge of the parent's legal obligation.³¹ Also, the parent may lose his income tax exemption for the child.

After ten years of joint returns for federal tax purposes, the distinction between the wife's income and the husband's income is some-

²⁸ Chamberlin v. Comm., 18 TC 164 (1952), *rev'd. and rem'd.* 207 F. 2d 462 (6th Cir. 1953), *cert. den.* 347 U.S. 918 (1954).

²⁹ WIS STAT. §§319.61 et seq., (1957).

³⁰ Rev. Rul. 55-469; CUM. BULL. 1955-2, p. 519.

³¹ Rev. Rul. 56-484, CUM. BULL. 1956-2, p. 23.

See Rev. Rul. 56-86, CUM. BULL. 1956-1, p. 449 which makes the \$3,000 annual exclusion available for gift tax purposes and Rev. Rul. 57-366, IRB 1957-32, p. 20 which holds that the securities will be included in the donor-custodian's gross estate on death before donee's 21st birthday.

times assumed to be nonexistent and the advantage of issuing corporate stock in the wife's name is often overlooked. Remember, however, that Wisconsin state returns are filed by husband and wife individually, that the husband is almost always in a higher bracket than the wife, and that substantial savings are therefore possible if corporate stock is issued in the wife's name and dividends thereon are reported on her individual Wisconsin return.

MISCELLANEOUS PROBLEMS

The time of incorporation presents a golden opportunity to make certain elections which are available only rarely in the ordinary course of business. A new taxable year can be adopted and, in addition to its other benefits, this permits the utilization of an initial short (less than 12 months) taxable period. Among the possible changes in accounting methods are a change in inventory valuation method, the adoption of a reserve method for bad debts instead of actual charge-offs, or a change from cash to accrual basis. Once adopted, each of these decisions is normally irrevocable.

Instead of creating one corporation, it may be advisable to split a business into its various components and incorporate in multi-corporate form. The principal advantages are the \$25,000 corporate surtax exemption and the \$60,000 accumulated earnings credit. Each of these is available to each corporation. Each corporation can select a different taxable year and make such other elections as are most practical. Also, it may be advisable for the individual organizer to retain certain assets in his own name. Real estate, for example, might be leased to the corporation thereby returning cash to the owner which will be partially offset by his depreciation deduction.

Finally, timing is important. If the business is expected to produce a loss during its early stages, it is generally best to postpone incorporation temporarily. In this way the losses can be set off against other income of the individual owner thereby reducing his tax, whereas the new corporation, with no income, may derive no tax benefit from the losses unless they can be utilized within five years as loss carry forwards under Sec. 172.

CONCLUSION

The importance of planning cannot be overemphasized. It is far easier to anticipate the problems of the corporate baby than to cure its ills at a later stage in its development. For example, the attorney has considerable latitude in choosing the number of corporations to operate a business before it is organized, but to split up an existing business into various entities so as to obtain surtax exemptions may be impossible. Preferred stock can be issued initially without the contamination of Sec. 306 but this opportunity is available only once un-

less additional capital is invested. A failure to recognize the effect of a taxable vs. a tax-free incorporation, a "thin" corporation, or almost any of the other problems discussed herein can result in unwelcome, unnecessary, and costly taxes. And, like the young man who murdered his parents and then pleaded for mercy on the grounds that he was an orphan, if we fail to carefully anticipate the ultimate result of each of our decisions, we have only ourselves to blame.