Family Income Shifting Within the Subchapter S Corporation

I. Introduction

Individual taxpayers are acutely aware of the progressive income tax. The tax varies from 14 percent to 70 percent of taxable income.[1] This progressive rate structure provides a strong incentive for income shifting within a family. If income can be shifted from a high tax bracket family member to a lower one, the family unit's aggregate tax liability will be reduced. Therefore, the family unit increases its after-tax income. The possibility of substantial tax saving via income shifting has stimulated the use of various devices to accomplish this objective.[2] This Note will examine the advisability of using the subchapter S corporation[3] to shift income within the family. The following example demonstrates the potential tax savings. *F*, the principal shareholder in a subchapter S corporation, transfers stock to his children or grandchildren. A transfer of stock which produces a shift of $5,000 of income from *F* in a high tax bracket to a minor child with no other income would result in a significant tax saving in a single year.[4] If this yearly tax saving is multiplied by ten or fifteen years, the tax saving for the family can accumulate to a substantial sum. However, there are potential problems since the Commissioner of Internal Revenue has counter-weapons to prevent any tax evasion schemes.[5] Nevertheless, tax saving can be attained if certain precautions are heeded. To understand what is permissible and what is not, a general review of income assignment is helpful.

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[1]Int. Rev. Code of 1954, § 1.

[2]*See, e.g.*, Klaus, *Tax Considerations in Choice of Family Organization*, 20 Okla. L. Rev. 35 (1967); Malone, *Income Splitting as a Means of Avoiding Taxes*, 19 Vand. L. Rev. 1289 (1966); Propp, *Spreading the Family Income*, 50 Taxes 197 (1972). Some of the more popular tax shifting devices have included the family partnership, corporation, trust, joint ownership, family employment, gift (or sale) and leaseback, joint venture, and interest free loans.

[3]Int. Rev. Code of 1954, §§ 1371-79. The popularity of the subchapter S corporation is primarily due to the absence of a corporate tax. The corporation is a mere conduit for earnings which are passed on to shareholders. Taxable income is realized only when the dividends are actually or constructively received by the shareholder.

[4]*Cf.* Int. Rev. Code of 1954, § 1. The magnitude of the saving depends upon the relative tax brackets of the father and child.

[5]The Commissioner is empowered to reallocate income, deductions, and credits to prevent evasion of taxes or to clearly reflect income. Int. Rev. Code of 1954, §§ 482, 1375(c).

II. Income Assignment Generally

The Commissioner for many years has vigorously opposed taxpayer efforts to reduce tax liability by assignment of income.[6] A favorite scheme of taxpayers was to contractually assign the right to future earnings to a minor child. By such assignment the taxpayer hoped to remove earnings from his gross income by shifting it to the gross income of a family member in a lower tax bracket. If successful, a substantial tax saving was realized. Because of the potentially large tax saving, it was only a matter of time before the Supreme Court eventually addressed the issue of income assignment. The inevitable occurred in the landmark case of *Lucas v. Earl.*[7] Mr. and Mrs. Lucas had entered into a contractual agreement under which all acquisitions of both parties were to be owned equally, including income from personal services. Nevertheless, the Supreme Court held that all of Mr. Lucas' salary and fees were attributable to him for tax purposes. The *Lucas* case established the principle that an anticipatory assignment of future earnings would be ineffective to shift the tax burden.[8]

Despite *Lucas,* taxpayers continued to be fascinated with the potential tax saving inherent in assignment of income schemes, and ingenious techniques were devised to shift income to low tax bracket family members. The Commissioner, armed with *Lucas,* vigorously resisted such efforts. One decade after *Lucas,* the issue of assignment of income was again before the Supreme Court in *Helvering v. Horst.*[9] Horst was the owner of interest-bearing coupon bonds. As the coupons matured, he would redeem them for interest income. Because he was in a higher tax bracket than his minor son, Mr. Horst transferred the unmatured coupons to his son and directed that interest payments be made to his son. The Commissioner objected to this tax saving arrangement on the grounds of *Lucas.* The Supreme Court agreed with the Commissioner and held that the father's transfer of the unmatured bond interest coupon to his son was insufficient to transfer the tax burden on the interest income. Perhaps the most enlightening part of the opinion was a statement by Mr. Justice Stone, writing for the Court.

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[6]*See generally* Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes,* 64 Yale L.J. 991 (1955).

[7]281 U.S. 111 (1930).

[8]*Id.* at 114. *See also* Burnet v. Leininger, 285 U.S. 136 (1932) (disallowing a purported assignment to the taxpayer's wife of a one-half share in his interest in a partnership). *Lucas* is perhaps best remembered by the fruit and tree metaphor: "[N]o distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." 281 U.S. at 115.

[9]311 U.S. 112 (1940).

> The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid.[10]

The Court concluded that even though Mr. Horst had directed that payment be made to his son, he had created the right to receive the payment. Therefore, he had to bear the tax burden of the coupon interest income.

Taxpayers also experimented with short-term trusts as an income assignment device. In a typical arrangement, a high tax bracket settlor conveyed income-producing corpus to a trustee, named a minor child or wife as beneficiary, but retained the power to revoke. The high tax bracket settlor reasoned that as long as the beneficiary received the income from the trust, the beneficiary would be the taxable entity and not the settlor, and, since the beneficiary was in a lower tax bracket than the settlor, a tax saving would be realized. Again, the Commissioner, relying on *Lucas*, perceived the short-term trust as merely another impermissible income-assignment device. The Supreme Court resolved the short-term trust issue in *Helvering v. Clifford*.[11] Mr. Clifford was the settlor of a five year *inter vivos* trust. He named his wife beneficiary but retained a substantial degree of control over the corpus. Mr. Clifford contended that the beneficial owner (his wife) was the taxable entity . The Court rejected this argument, holding that even though the settlor was not the apparent owner of the corpus, he remained the taxable entity because he retained too much control over the corpus. Therefore, Mr. Clifford, and not his wife, was taxed on the trust income. Unfortunately, the Court did not establish any clear standards for determining under what conditions, if any, trust income would not be taxable to the settlor. Much uncertainty was resolved by the "Clifford Rules" in the Internal Revenue Code of 1954.[12] Generally, these rules provide that the settlor will be taxed on trust income of any portion of corpus in which he has a reversionary interest that may take effect within ten years after the last transfer to the trust.[13] In addition, if the settlor retains the sole power to control the disposition of either income or corpus, he will be taxed on the trust income.[14] If he

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[10] *Id.* at 119.

[11] 309 U.S. 331 (1940). The settlor retained the power to sell the corpus, to reinvest the income, or to pay over to the beneficiary as he alone might choose.

[12] INT. REV. CODE OF 1954, §§ 671-78.

[13] *Id.* § 673(a).

[14] *Id.* § 674(a).

retains various other types of control, he will also be taxed.[15] Thus, income assignment via the short-term trust is perilous. However, such trusts can yield significant tax saving by shifting income in certain limited factual settings.[16]

The income assignment area continues to be the source of much controversy.[17] Upon this controversial background, a new concept was added to the tax law—the subchapter S corporation.[18] Arguably, subchapter S is particularly adapted to facilitate the assignment of income, especially within the context of a family.

III. Subchapter S Corporation

Since the inception of the federal tax on corporate income[19] in 1909,[20] the theory and rationale of the tax and its relationship to the individual income tax have been subjects of controversy.[21] In his 1954 Budget Message to the 83d Congress, President Eisenhower recommended legislation permitting certain corporations to escape the corporate income tax because, in his view,

> [s]mall businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties.[22]

The President's proposal encountered much opposition. Nevertheless, four years later Congress adopted the proposal as a part of the Technical Amendments Act of 1958.[23] The newly adopted

[15] *Id.* §§ 675-77.

[16] Propp, *Spreading the Family Income,* 50 Taxes 197, 203 (1972). *See generally* Barnett, *Short-Term Trusts Are Not Dead!,* 3 Tax Advisor 80 (1972); Weinstock, *The Short Term Trust: A Worthwhile Tax Saving Tool,* 50 Taxes 153 (1972).

[17] *See, e.g.,* Ferrer v. Commissioner, 304 F.2d 125 (2d Cir. 1962), *discussed in* Eustice, *Contract Rights, Capital Gain and Assignment of Income: The* Ferrer *Case,* 20 Tax L. Rev. 1 (1962). *See generally* Malone, *Income Splitting as a Means of Avoiding Taxes,* 19 Vand. L. Rev. 1289 (1966).

[18] Int. Rev. Code of 1954, §§ 1371-78. *See* note 3 *supra.*

[19] Int. Rev. Code of 1954, § 11.

[20] Payne-Aldrich Tariff Act of 1909, 36 Stat. 11. An earlier corporate income tax, enacted in 1894, was held unconstitutional in Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895), on the ground that a federal tax on income from real and personal property was a direct tax requiring apportionment among the states on the basis of population. *See* U.S. Const. art. I, § 9, cl. 4.

[21] *See, e.g.,* Tax Institute of America, How Shall Business Be Taxed? (A. Alvord, ed. 1937).

[22] 100 Cong. Rec. 571 (1954) (tax recommendations in Budget Message of Jan. 21, 1954).

[23] Act of September 2, 1958, Pub. L. No. 85-866, tit. I, § 64(a), 72 Stat. 1650.

statute provided for what has become popularly referred to as the subchapter S corporation.[24] Except for certain capital gains income,[25] a subchapter S corporation does not pay federal income tax although it is a corporation for all other purposes. Thus, the double taxation of corporate earnings is avoided.[26] Also, some states, including Indiana, give deference to the subchapter S concept and do not levy a state corporate income tax.[27] Thus, the subchapter S election has become very popular[28] among eligible[29] corporations.

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[24]INT. REV. CODE OF 1954, §§ 1371-78. For a discussion of subschapter S, see 7 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION ch. 41B (1967); Coplin, *Subchapter S—Election of Small Business Corporations,* 51 KY. L.J. 308 (1962); Coplin, *Partnership or S Corporation? A Check List of the Tax Factors in the Choice,* 12 J. TAXATION 32 (1960); Cunningham, *Subchapter S Corporations: Uses, Abuses, and Some Pitfalls,* 20 MD. L. REV. 195 (1960); Lebrun, *Subchapter S Corporations,* 39 N.D.L. REV. 341 (1963); Moore & Sorlien, *Adventures in Subchapter S and Section 1244,* 14 TAX L. REV. 453 (1959); Note, *Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958,* 72 HARV. L. REV. 710 (1959).

[25]INT. REV. CODE OF 1954, § 1378. Generally, the corporation is liable for the tax only if the taxable income of the corporation for the year is more than $25,000, and the excess of net long-term capital gain over net short-term capital loss is *both* more than $25,000 and more than 50 percent of taxable income. Treas. Reg. § 1.1378-2 (1968).

[26]*See* INT. REV. CODE OF 1954, §§ 1372(b), 1373(a)-(b). Earnings of a regular corporation are taxed at the corporate level, *id.* § 11, and again at the individual level, *id.* § 61(a)(7), with the exception of the $100 exclusion, *id.* § 116.

[27]IND. CODE § 6-3-2-3(b) (Burns 1972) (Adjusted Gross Income); *id.* § 6-3-7-1(a) (Gross Income Tax); *id.* § 6-3-8-1 (Supplemental Net Income Tax). The Indiana Department of Revenue has provided that

> [s]mall business corporations are generally not subject to the Gross Income Tax Act, the Adjusted Gross Income Tax Act, *or the Supplemental Net Income Tax Act,* if they have elected to file as a small business corporation for federal income tax purposes under section 1372 of the Internal Revenue Code.

INDIANA DEP'T OF REVENUE, CIRCULAR IT-18 (May 1, 1974 rev.) (emphasis in original and citations omitted).

[28]*See* U.S. TREASURY DEP'T, STATISTICS OF INCOME, BUSINESS INCOME TAX RETURNS 3 (1972). These statistics indicate that more than 14 percent of the corporations reporting for income tax purposes in 1969 had made the subchapter S election.

[29]INT. REV. CODE OF 1954, § 1372. Generally, an eligible corporation is one that meets the following requirements: (1) It must be a domestic corporation; (2) there must be no more than ten shareholders; (3) all shareholders must be individuals or decedents' estates; (4) no nonresident alien may be a shareholder; (5) the corporation may not have more than one class of stock; (6) the corporation cannot receive more than 80 percent of its gross receipts from sources outside the United States; (7) the corporation cannot receive more than 20 percent of its gross receipts from interest, dividends, rents, royalties, annuities, and gains from sales or exchanges of securities, and (8) all shareholders must consent to the election. For a general discussion of eligibility

In addition to avoiding double taxation, subchapter S offers other advantages to the family business enterprise. Subchapter S arguably condones certain types of income shifting which can substantially reduce the family unit's aggregate income tax liability. Two basic questions arise: (1) What income shifting devices are available to a family business that is operating in the subchapter S legal structure? (2) Is there a solid legal basis for employing these income shifting devices? Attention herein is directed to these basic questions.

A. *Constructive Dividend*

The constructive dividend provision of subchapter S appears to open the door to limitless assignments of income. Much of what the Commissioner had fought for and won in *Lucas v. Earl*[30] and *Helvering v. Horst*[31] may have been subverted by section 1373(b) of the Internal Revenue Code of 1954, which provides in part:

> Each person who is a shareholder of an electing small business corporation on the *last day* of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year.[32]

By merely varying the identity of persons holding the stock of the corporation on the last day of its taxable year, the constructive dividend provision allows taxpayers to freely shift income. This provision is especially appealing to family enterprises. Consider the following situation. A shareholder father owns all the stock of a subchapter S corporation. Near the end of the corporation's taxable year, the accountant reports that the corporation's taxable

requirements, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.02, at 6-5 (abr. ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; Ekman, *Subchapter S: Problems of Election and Terminations*, 1970 N.Y.U. 28TH INST. ON FED. TAX. 475; Odmark, *A Practitioner's Guide to Subchapter S Planning Opportunities and Pitfalls*, 30 J. TAXATION 360 (1969).

[30] 281 U.S. 111 (1930).

[31] 311 U.S. 112 (1940).

[32] INT. REV. CODE OF 1954, § 1373(b) (emphasis added). Subsections 1373(c) and (d) define undistributed taxable income as taxable income (without regard to the net operating loss deduction or to the deductions allowed by sections 241 to 247) less the section 1378 tax on capital gains and less actual distributions from current earnings and profits. See note 25 *supra*.

income for the year will be approximately $100,000. This income places the father in a high tax bracket. If he shifts the ownership of stock, by sale or gift, to his minor children by the *last* day of the corporation's taxable year, he effectively shifts the dividends and the consequent tax burden to a lower tax bracket taxpayer. Thus, a substantial tax saving accrues to the family unit. However, a substantial gift of stock may cause gift tax consequence to the father.[33]

On first impression, the constructive dividend feature might appear to be a congressional oversight. Apparently not, however, for a different method was devised to apportion a corporate net operating loss among shareholders. Losses are apportioned pro rata according to the length of time the particular shareholder owned his stock.[34] An example will highlight the difference in treatment of dividends and losses. *F* is the sole shareholder of a subchapter S corporation. He transfers stock to *M* prior to the end of the corporation's taxable year. If the corporation has taxable income for the year, the constructive dividend feature of section 1373(b) imputes all the dividend income to *M*, for he held the stock on the last day of the corporation's taxable year. But, if the corporation was less successful and had experienced a net operating loss, only 1/365 of the loss would pass through to *M*, for he held stock only 1/365 of the corporation's taxable year. Why did Congress provide for such disparate treatment? No reason is found in the statute, regulations, or legislative history. Perhaps it is a matter of simplicity and administrative convenience to impute dividends to the owner of stock held on the last day of the corporation's taxable year. But if administrative convenience is the reason, why were losses not allocated similarly? This question has been raised by commentators, and corrective legislation has been suggested to solve the disparate treatment features.[35] Nevertheless, Congress to date has not removed this loophole. The undistributed taxable income of a subchapter S corporation continues to be taxed to persons holding its stock on the last day of the corporation's taxable year.

The constructive dividend device appears to be a relatively safe way to split income among family members. However, the Commissioner is not entirely weaponless. A Treasury Regulation provides that a donee or purchaser of stock in a subchapter S corporation will not be regarded as such unless he acquires the

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[33]INT. REV. CODE OF 1954, § 2501.

[34]*Id.* § 1374(a). The corporation's net operating loss is prorated and passed through to each shareholder as a deduction against other income of the shareholder. The pro rata share is a function of the shareholder's interest in the corporation and the length of time he held his interest in the corporation during that taxable year.

[35]Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 VA. L. REV. 61, 81 (1960).

stock in a bona fide transaction.[36] The Regulation adds the additional warning that family transactions will be closely scrutinized. The Tax Court had an opportunity to apply this Regulation in *Henry D. Duarte.*[37] In *Duarte,* the sole owner of a subchapter S corporation purported to transfer 50 percent of the stock to his minor children. Subsequently, all dividends, actual and constructive, were reported on the corporation's information returns and on the individual returns of the father and his two minor children. The transfer was in compliance with the New York Uniform Gifts to Minors Act,[38] with the mother serving as custodian of the stock. Additionally, the father filed a gift tax return, although there was no gift tax liability. Nevertheless, the Commissioner argued, and the court held, that the gift was not a bona fide transfer for purposes of federal income taxation. The court noted that neither child had actually received the dividends. At all times the father had exercised complete dominion over both the corporation and the dividends. The court, in support of its conclusion, alluded to the substance versus form dichotomy—if a transaction is complete in form but lacks substance, it will not be recognized as effective for income tax purposes.[39] Thus, after the *Duarte* decision, it is clear that if income splitting among family members is to be effective, there must be a bona fide transfer of stock. Further, the Commissioner has a procedural advantage since the burden of proving a bona fide transfer is on the taxpayer.[40]

Another pitfall to be aware of when transferring shares of a subchapter S corporation to family members is that the right to receive distributions of previously taxed income (PTI) is not transferable.[41] A basic feature of subchapter S is that earnings are imputed to shareholders at the end of each year for tax purposes, regardless of whether or not dividends are actually distributed. Subsequently, when the shareholder receives his PTI, the distribution to him is nontaxable. However, the right to receive PTI without realizing income is personal to the shareholder who

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> A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized.

Treas. Reg. § 1.1373-1(a)(2) (1959).

[37] 44 T.C. 193 (1965). *See* Michael F. Beirne, 52 T.C. 210 (1969).

[38] N.Y. EST., POWERS & TRUSTS §§ 7-4.1 to -4.10 (McKinney 1967).

[39] 44 T.C. at 197. *Accord,* Gregory v. Helvering, 293 U.S. 465 (1935).

[40] 44 T.C. at 197.

[41] INT. REV. CODE OF 1954, § 1375(d)(1); Treas. Reg. § 1.1375-4(e) (1959).

owned the stock when the PTI accrued. If the stockholder transfers the stock without having actually received his PTI, the transferee does not acquire the right to do so.[42] A distribution to the transferee is treated as a taxable dividend. Thus, only current and future earnings will be shifted to the lower tax bracket family member. The inability to transfer PTI tax free limits the flexibility of a subchapter S corporation for income shifting purposes.

If the transfer of stock to a family member is by way of a gift, a gift tax liability may arise.[43] Any taxable gift would reduce the potential income tax savings but would decrease the donor's taxable estate and thus reduce estate taxes upon the donor's death.[44] Also, a gift of closely held corporation stock invariably presents valuation problems.[45] Clearly, all three taxes must be considered by the tax planner.

In summary, the constructive dividend peculiar to subchapter S can be successfully employed to minimize the family's aggregate tax liability. Success will depend upon a bona fide transfer of the stock. Other problems include the transferor's burden of proving a bona fide transfer, the loss of the right to receive any PTI tax free, and gift tax and valuation problems.

B. *Minimum Reasonable Salary*

Another possible technique for shifting income within a family enterprise using a subchapter S corporation is to compensate the father-shareholder-employee with the minimum reasonable salary. The payment of a low salary leaves more earnings and profits to be distributed to other family member shareholders, either as actual or constructive dividends.[46] This technique can effectively shift income from a father in a high tax bracket to his children in lower tax brackets. For example, assume that there is a range of reasonable annual salaries for the shareholder-employee from $15,000 to $30,000. The payment of the lowest reasonable salary accomplishes two objectives: (1) Less income goes into the high tax bracket shareholder-employee's gross income, and (2) more income remains available for distribution by the corporation to family

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[42]A transferor who later reacquires stock in the corporation during the same uninterrupted election may then employ his old PTI account. To this extent his right to receive PTI is not lost. Treas. Reg. § 1.1375-4(e) (1959).

[43]*Cf.* Int. Rev. Code of 1954, § 2501.

[44]*Cf. id.* §§ 2001-2207.

[45]Jacobowitz, *Is Subchapter S a Viable Planning Tool?*, 1971 N.Y.U. 29th Inst. on Fed. Tax. 1373, 1395.

[46]*Cf.* Int. Rev. Code of 1954, § 1373(d). A deduction for salaries is authorized by subsection 162(a)(1). The salary deduction is taken in arriving at the corporation's taxable income.

shareholders in lower tax brackets. The net result is an aggregate tax saving for the family unit. For example, by shifting $15,000 from the father who is in the 50 percent tax bracket to other family members in the 25 percent tax bracket, the tax liability is reduced from $7,500 to $3,750—a tax saving of $3,750.

The above noted feature of a subchapter S corporation is markedly different from a regular (subchapter C) corporation. A shareholder-employee of a regular corporation wants to be paid the *largest* reasonable salary. Furthermore, as the salary increases, the amount of earnings and profits subject to the corporate tax decreases.[47] In fact, the corporate tax can be avoided entirely if salaries and other reasonable corporate expenses totally exhaust earnings and profits of a regular corporation.[48]

Section 1375(c) imposes a restriction on the shifting of income within a subchapter S corporation by requiring the payment of a minimum salary to the high tax bracket shareholder-employee. This section gives the Commissioner the power to reallocate distributions among shareholders of a corporation who are members of the recipient's family if such allocation is "necessary in order to reflect the value of services rendered to the corporation by such shareholders."[49] Thus, if an unreasonably low salary is paid to the shareholder-employee, additional income may be allocated to him by the Commissioner from dividends that otherwise would have been shifted to other members of his family. Of course, if such reallocation occurs, income shifting and the accompanying tax saving will have been frustrated. This possibility was made clear to taxpayers by the case of *Pat Krahenbuhl*.[50] In that case the father made bona fide transfers of shares of his solely-owned subchapter S corporation to his four minor children under the Alabama Uniform Gifts to Minors Act.[51] In the subsequent two

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[47]*Cf.* INT. REV. CODE OF 1954, § 11.

[48]Klaus, *Tax Considerations in Choice of Family Organization*, 20 OKLA. L. REV. 35, 46 (1967).

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> Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the Secretary or his delegate between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 704(e)(3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

INT. REV. CODE OF 1954, § 1375(c). Subsection 704(e)(3) defines the family of any individual as "his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

[50]27 CCH Tax Ct. Mem. 155 (1968).

[51]ALA. CODE §§ 47-17-154(1)-(10) (1973).

years, the father received salaries of $4,800 and $7,200, respectively. The remainder of the corporation's earnings and profits were distributed to the shareholders. The Commissioner concluded that neither of the salaries reflected the value of the father's services to the corporation and allocated additional income to the father for the two years in question. The Tax Court upheld the Commissioner's allocation with respect to the $4,800. The court concluded that a yearly salary of $4,800 did not accurately reflect the value of services the taxpayer rendered to the corporation. However, the court found the $7,200 salary reasonable. In valuing the services rendered, the court gave consideration

> to all the facts and circumstances of the business, including managerial responsibilities, and the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation.[52]

The court, in establishing the value of the father's services to the corporation at $7,200 per year, considered the following facts: (1) The newly organized corporation was inexperienced in determining salaries, (2) the taxpayer was technically competent and had previously earned $7,500 per year in a similar position, (3) the taxpayer was the guiding force of the corporation, and (4) there was no specific scheme afoot to avoid taxes.[53] *Krahenbuhl,* although admittedly vague, gives the taxpayer an idea of some of the factors a court will consider in determining the value of the shareholder-employee's services to the corporation.

Krahenbuhl also held that the burden of proof is on the taxpayer to show error in the Commissioner's allocation.[54] Thus, once the Commissioner makes a reallocation, his determination is afforded a presumption of correctness. This procedural advantage could be the tipping factor in many situations.

In *Charles Rocco,*[55] the taxpayers fared better than those in *Krahenbuhl.* A husband and wife were shareholder-employees of a subchapter S corporation. Their children and grandchildren held a majority of the shares. During 1966, the husband and wife received salaries of $15,000 and $12,000, respectively, and dividends of $1,400 and $1,700, respectively. Substantial dividends were distributed to lower tax bracket family shareholders. The Com-

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[52]27 CCH Tax Ct. Mem. at 157. This test was previously promulgated in Treas. Reg. § 1.1375-3(a) (1958). *Cf.* Botany Worsted Mills v. United States, 278 U.S. 282 (1928); 1 CCH 1976 STAND. FED. TAX REP. ¶ 1372.

[53]27 CCH Tax Ct. Mem. at 158.

[54]*Id. See also* Roth Office Equip. Co. v. Gallagher, 172 F.2d 452, 456 (6th Cir. 1949).

[55]57 T.C. 826 (1972).

missioner determined that the salaries to the husband and wife did not reflect the value of their services to the corporation. Consequently, the Commissioner reallocated the dividends. However, the Tax Court reversed the Commissioner's determination. The court followed the traditional standard for determining a "reasonable allowance for salaries or other compensation for personal services actually rendered."[56] The traditional standard for reasonable salary allowances gives consideration to the following factors: (1) The nature of the services performed, (2) the need for any special ability or skill in performing them, (3) the responsibilities involved, and (4) the amount of time required to perform the services.[57] The *Rocco* court noted that the husband and wife each devoted only ten hours per week to the management of the corporation. Their management activities were largely ministerial in character. They took a two and one-half month vacation to Florida during which time a substitute was hired for $2,000. Their accountant testified that for an annual salary of from $4,000 to $6,000, a competent individual not having an interest in the corporation could not be hired to replace either the husband or wife. Thus, the court concluded that the salaries received fairly reflected the value of the services performed.[58]

Even after *Krahenbuhl* and *Rocco*, no definite standard for reasonableness of salary exists. Reasonableness remains a question of fact to be ascertained upon an analysis of the facts of each case.[59] Therefore, a shareholder-employee of a subchapter S corporation desiring to shift income by receiving a low salary should be wary. However, the opportunity for income shifting within the family by this means remains available if kept within reasonable bounds.

The "family" of the shareholder is defined in section 1375(c) by reference to an area of the Code applicable to family partnerships. The shareholder's family to which the reallocation provision of section 1375(c) is applicable includes the spouse, ancestors, and lineal descendants.[60] Commentators have drawn attention to the basic incongruity caused by using the same definition of family for both the subchapter S corporation and the family partnership.[61] Although both the partnership and subchapter S rules were de-

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[56] *Id.* at 831. *See* Walter J. Roob, 50 T.C. 891, 898 (1968); INT. REV. CODE OF 1954, § 162(a)(1).

[57] 57 T.C. at 831. *See* Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949); Dahlem Foundation, Inc., 54 T.C. 1566, 1580 (1970).

[58] 57 T.C. at 833.

[59] *Cf.* Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).

[60] INT. REV. CODE OF 1954, §§ 1375(c), 704(e)(3). Subsection 704(e)(3) provides the definition of family of an individual as "only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

[61] B. BITTKER & J. EUSTICE ¶ 6.05(2), at 6-20.

signed to prevent intra-family assignment of income,[62] the subchapter S rules are, in some respects, much broader.[63] Unlike the partnership provision, section 1375(c) permits a reallocation to reflect the value of a shareholder's services not only where the other members of his family acquired their stock from him, but also where their stock was acquired from outsiders.[64] For example, the source of the family members' stock is irrelevant to the Commissioner's power to reallocate dividends of a subchapter S corporation.[65] However, only partnership interests which are transferred by gift to members of the transferor's family will invoke the partnership reallocation rules designed to prevent assignment of income.[66] Thus, the subchapter S provision granting the Commissioner power to reallocate dividends is much broader than similar provisions with respect to family partnerships.[67] Although there is no apparent explanation for this disparate treatment, it remains.

One oddity has escaped the scope of section 1375(c). The section is aimed at the obvious ploy of a father-shareholder working for the corporation at an inadequate salary, thus transferring income via larger dividends to his family members who are shareholders. But what if the father conveys *all* of his stock to his family? Obviously, he is no longer a shareholder. Thus, if his salary does not reflect the value of his services to the corporation, the Commissioner does not have section 1375(c) available for use in reallocating dividends. Any reallocation by the Commissioner would presumably be based on general assignment of income principles.[68]

In summary, a shareholder-employee of a subchapter S corporation can successfully shift income to family members who are also shareholders of the subchapter S corporaton by having the corporation pay him the minimum reasonable salary. This technique leaves more corporate earnings and profits to be distributed as dividends. Successful shifting of income by this device will depend largely upon compliance with section 1375(c). This section gives the Commissioner the power to reallocate dividends among the family members if he determines that the salary paid to the shareholder-employee was unreasonably low. Once a reallocation is made, the burden of proof is on the taxpayer to show that the salary

[62]*Cf.* Beck, *Use of the Family Partnership as an Operating Device—The New Regulations*, 1954 N.Y.U. 12TH INST. ON FED. TAX. 603.

[63]B. BITTKER & J. EUSTICE ¶ 6.05(2), at 6-20.

[64]*Id.*

[65]*Cf.* INT. REV. CODE OF 1954, § 1375(c).

[66]*Id.* § 704(e).

[67]B. BITTKER & J. EUSTICE ¶ 6.05(2), at 6-20.

[68]*Cf.* Lucas v. Earl, 281 U.S. 112 (1940).

was reasonable. The Commissioner's power to reallocate dividends is limited to the shareholder's family. Thus, paying a minimum salary to a shareholder-employee can effectively shift income if kept within reasonable bounds.

C. Conveyance and Leaseback

Perhaps the most common device to shift income within the family unit is the conveyance and leaseback. For example, a 50 percent tax bracket father has income from several sources, one of which is a farm operation that produces taxable income of $30,000 each year. Low tax bracket family members organize a partnership, and the father then conveys the real estate used in the farming operation to the partnership. By a pre-arranged agreement, the father then leases back the property he transferred to the partnership and uses the property in his farming operation. This arrangement has a twofold effect. First, the father is now entitled to a deduction for rental payments made to the corporation for the use of the property.[69] Secondly, the corporation is merely a conduit through which the rental income is passed as dividends to its shareholders, the low tax bracket family members. Consequently, the family unit's aggregate tax liability is reduced. When a father in the 50 percent tax bracket leases back property from such a partnership and pays a $30,000 rental payment to the partnership, the $30,000 is passed through the partnership to family members in the 25 percent tax bracket. By shifting the $30,000 from the father to other family members, the family unit has reduced its tax liability from $15,000 to $7,500—a tax saving of $7,500. Additionally, the father now has a $30,000 deduction for rental expense that he did not have prior to the leaseback. The $30,000 deduction can be used to offset income from other sources. Consequently, the family unit reaps additional tax saving.

In most circumstances, the subchapter S corporation would be ill-suited for the conveyance and leaseback arrangement due to the restrictions placed upon the amount of passive investment income permitted the subchapter S corporation.[70] The subchapter S

[69]The transaction will not be respected for tax purposes if it is a sham and the transferor retains significant control over the transferees. A bona fide transfer and retention of no control by the transferor will, however, bring about the desired results. *See* Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Alden B. Oakes, 44 T.C. 524 (1965).

[70]INT. REV. CODE OF 1954, § 1372(e)(5). The subchapter S election is terminated if in any taxable year more than 20 percent of the corporation's gross receipts constitutes "passive investment income." This is defined in subsection 1372(e)(5)(C) to include gross receipts from royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stock or securities. Under an amendment added in 1966, this limitation does not apply

corporation can receive no more than 20 percent of its gross receipts from passive type investments such as rent. If rental income exceeds the 20 percent limitation, the subchapter S status is automatically terminated.[71] In the normal conveyance and leaseback arrangement, rent would constitute a majority of the income. Consequently, the subchapter S corporation is ill-suited as the conduit corporation. If the conveyance leaseback arrangement is used, the regular corporation, a partnership, or a trust would better facilitate the shifting objective.

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so long as the corporation is in either its first or second taxable year of active conduct of business operation and passive investment income is less than $3,000. *Id.* § 1372(e) (5) (B).

[71]*Id.* § 1372(e) (5) (A).