1961

A general survey of the basic determinants in the businessman's choice of the available business forms of organization

BOSTON UNIVERSITY

College of Business Administration

THESIS

A General Survey of the Basic Determinants in the Businessman's Choice of the Available Business Forms of Organization

by

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Submitted in partial fulfillment of the requirements for the degree of

MASTER OF BUSINESS ADMINISTRATION

1961

This thesis was prepared under my supervision and approval is hereby indicated.

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INTRODUCTION

Purpose and Scope of Thesis

There are definite business forms in our economy which have developed in response to the demands of our changing cultural environment. Each form has certain characteristics which offer the entrepreneur a variety of legal, financial, and tax incidents that may be either beneficial or detrimental to his desired objectives. This study shall investigate the forms of organization which are available to the investor of small business.* The importance of this study is based on the practical aspect that the courts, governments, and businessmen will inevitably force any given business into one of the several established forms prevalent in our society. Because of this fact, each participant should be cognizant of the legal consequences which automatically flow from the decisive

*For the purpose of this paper small business means a business form where the ownership, active management, and control of the enterprise are held by a limited number of participants. The business must be permissible by law in the private sector of our economy with the basic objective of profit-making. This definition excludes publicly owned businesses which are usually listed on our stock exchanges and have the corporate form. In contrast the closely held businesses do not actively change ownership interests or managerial hands. Various regulatory governmental business entities such as public utilities and municipal corporations as well as charitable institutions are excluded by definition. The organization of a business is defined as the formation or original creation of a business enterprise in any one of the forms accepted by the social framework of our economy. These definitions are not necessarily controlling in this type of study; however, it is essential that workable definitions be adopted to avoid confusion.

elements and attributes of his operational form. It is natural that one may ask himself which form will produce the most advantageous consequences, both legal and financial, and, at the same time, afford the means of procuring all the other desirable features expected in the operations of business. If choice is viewed in this manner, then it is apparent that a careful and thoughtful analysis of each form of organization be a preliminary procedure before the entrepreneur arrives at his decision. Furthermore, choice plays a vital role because the firm's relations with its owners and third persons fixes for a reasonably long time the rights, duties, privileges, and obligations of itself and its owners. This becomes more apparent when the company is subject to litigation and the practical businessman becomes more aware of the legal consequences resulting therefrom.

Need for This Study

The writer believes that the average small businessman does not fully understand the incidents of his business form and, that if he did have knowledge of the legal and financial consequences of each form and approached the problem of choice to be outlined, he would most likely select a business form of organization different from the one he originally contemplated. Many businessmen, in small business especially, do not

understand the relationship of their business interests with that of their personal wealth and the mutual effect each has on the other. The more complex our system of laws, taxation, and estate planning becomes, the more importance is attached to the form of business organization adopted by businessmen to protect and, at the same time, to employ the optimum use of the capital resources devoted to the business enterprise. It is not here contended that once a study of each business form is made and once the choice is decided all other factors associated with the success of a business venture will naturally fit into place and thereby guarantee the expected results from the investment. There is not one utopian business form that will grant all the elements desired. There is not one form of organization that, by itself, will insulate the investor from failure. Nevertheless, if the entrepreneur has a basic knowledge of his business's legal and financial characteristics, he will be aware of the consequences that flow from his and the company's acts. Such knowledge will assist him in the elimination of the many risks always present in any business investment.

Method of Approach

To approach the problem of choice, the writer proposes to analyze and compare the basic characteristics of each available form of business organization. This

approach will assist the investor in his selection of that form which is "best" for his particular circumstances. When form is in question, the entrepreneur must first reflect upon the desirable features required by him before his participation in the venture in order to better determine the method that will fulfill his individual needs. After this comparative analysis and survey of the basic elements of each form, federal taxes and estate planning shall be separately discussed displaying their effect in the ultimate choice of business organization.

Review of Past Studies

Many books have been devoted to the relative advantages and disadvantages of each business form.* These published volumes have concentrated on the comparative incidents of each form and the factors basically distinguishing one from the other. In addition to the more lengthy works, there are many law review articles and other professional articles published in magazines and journals discussing one or more of the specific problems in this type of comparative study. Furthermore, several professional "service" companies solicitous to the needs of professional men have also covered the comparative incidents of the business forms in specialized

*References to books, journals, professional articles, and service publications are included in the bibliography of this paper.

areas of study. Few of the articles or books read by the writer have discussed all of the determinants of choice as shall herein be included. In addition, the conclusions as developed by the prior works seem indefinite and vague.

The writer shall attempt to coordinate past studies and to develop basic principles in order to guide the investor in his solution of this most important problem of choice. It is expected that this study should not only be useful in helping new investors but also in aiding participants already in business who may be operating at a disadvantage because of their lack of approaching this problem as suggested.

Available Forms of Organization

There are presently in our society six basic forms of business organization and one recently developed hybrid form which is available to the small investor. They are the sole proprietorship, the general partnership, the limited partnership, the joint stock company, the business (Massachusetts) trust,* the corporation, and the hybrid form, hereinafter referred to as the pseudo-corporation.**[1]

The investor must make his choice from these

*Not to be confused with the common-law trust often employed in estate planning to maintain and preserve one's personal wealth.
**The Research Institute of America labels this form as a pseudo-corporation.

forms in order to organize his business for profit. In the discussion of the tax aspects of the business organization, it is more practical to think in terms of the individual (sole proprietorship), the general partnership, and an association (corporation, business trust, and joint-stock company).* [2] The pseudo-corporation has all the legal and financial characteristics of the corporation but is treated differently for federal tax purposes. [3] The same attributes discussed for a corporation shall in all respects apply equally to the pseudo-corporation except in the discussion of its tax aspects. All investors should be familiar with the basic factors that make-up each form and the important differences between them.

*The income tax imposed on the several forms are accordingly categorized under the Internal Revenue Code.

GENERAL DESCRIPTION OF AVAILABLE FORMS

Sole Proprietorship

The sole proprietorship is a pretentious term for one who is doing business for himself and which is not otherwise classified as one of the other forms.[4] The creation of a proprietorship requires little or no formalities for its existence. The very fact that an individual commences his business without further concernment is sufficient within itself to form this type of business organization. The scope of activity is unlimited as to geographic boundries and operations. The right and privilege of doing business as an individual proprietorship in every state of the union is a fundamental freedom guaranteed by the Federal Constitution of the United States.[5] The entire management and ownership of the business rests solely in the individual owner and his activities are limited only by the laws pertinent to the citizens of the nation.* The sole proprietorship is the typical form usually associated with the local merchant such as the neighborhood market

*The restrictions which are imposed on this form usually come under the police powers of the state. They include building permits, zoning laws, health requirements, and such laws which govern the admission to the professions as law, accountancy, and medicine. All of the restrictions imposed on the sole proprietorship apply equally to the other business forms.

or drugstore. When the individual proprietorship becomes successful in its operations, it frequently assumes the status of one of the other forms of business organization.*

General Partnership

The general partnership has many of the legal characteristics of the sole proprietorship; it is the simplest form of doing business when two or more persons wish to enter a business jointly. Many of the partnerships are created similarly to the proprietorship in the sense that there are little or no formal procedures essential to its creation. The partnership is legally created by an informal or written contract and the very fact of two or more persons joining together in the same enterprise as co-owners and with active participation in the management of the business for the purpose of making and sharing profit is sufficient to create this popular form of doing business.** [6] The inter-relations of the partners are largely governed by statute in absence of contract to the contrary.*** [7] Thirty-six states and

*However the individual may be limited in his choice of business form if state laws prohibit certain professions as medicine, law, and accountancy from incorporation.
**Section 6 of the Uniform Partnership Act defines partnership as "an association of two or more persons to carry on as co-owners in a business for profit."
***In absence of an agreement between the partners, the legal relationship is analogous to the Laws of Descent and Distribution in the absence of a will. The statute governs the rights and duties of the parties in interest.

territories of the United States have adopted the Uniform Partnership Act which is a codification of the common law governing the internal and external activities of the partnership. In absence of a contrary agreement between the parties, the relations of the partnership with third parties are also based on the law of agency which has been well developed in American Jurisprudence.[8] The businessman in the American economy has favorbly accepted the general partnership and he has employed it with success in practically all types of business enterprises.

Limited Partnership

The limited partnership is a device possible only through an enabling statute usually in the form of the Uniform Limited Partnership Act.[9] The limited partnership allows businessmen to invest in a general partnership in return for a share of the expected profits without incurring the same risks and liabilities of the general partners.* Since this form of doing business is a creation

*Section 1 of the Uniform Limited Partnership Act defines the limited partnership as "... a partnership formed by two or more persons under the provisions of section 2, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership." Section 2 prescribes the essential formalities to create this business form setting forth such requirements as filing a sworn certificate with the Secretary of State giving the name, character, location of the business, name and address of the partners, type and amount of property contributed by each limited partner, etc.. Fourteen requirements must be included if pertinent in the articles of limited partnership.

of the state, it is necessary that all the formalities as expressed in the enabling statute are strictly followed in order that the limited partner preserves his legal status in the business.[10] Thirty-five states and territories of the United States have adopted the Uniform Limited Partnership Act.[11] This statute prescribes the method by which limited partners may insulate themselves from the onerous aspects of the general partnership such as unlimited personal liability for all legitimate debts of the firm.

Joint-Stock Company

The joint-stock company is a highly organized partnership with a relatively large number of partners or "members" whose ownership interests are represented by transferable shares.[12] This business form is created by a contract which need not be formalized unless otherwise provided by statute. Because of the usual number of investors and management complexities, the company is most frequently embodied in a written document called the "articles of association".[13] The articles usually set-forth the individual interests of the members and provide for a central body to manage the daily functions of the enterprise. Historically the joint-stock company was an attempt to create an effective business organization which permitted many investors to contribute capital

in different amounts with corresponding ownership interests.[14] The modern business corporation has almost wholly superseded this form of organization in the American scene.

Business (Massachusetts) Trust

The business trust, frequently referred to as the Massachusetts Trust, is an unincorporated form of organization in which the legal title and management of the assets are in the name of trustees. The trustees control the entire operations of the business for the benefit and profit of the investors called beneficiaries.* The ownership interests of the business are represented by transferable debentures. This form of organization is created by a written contract usually called a trust agreement which sets forth the terms of the trust, the powers and duties of the trustees, and the respective interests of the beneficiaries.[15] Although the business trust may in many states be created without statutory formality or state sanction, in Massachusetts there is a statute which governs the legal requirements of its inception and existence.[16] The business trust is not popular in many states because of the tendency of the courts and legislatures to reject it as a workable form of business organization. This form of organization has a special

*The term Massachusetts Trust has been used because of its initial development and acceptance in the State of Massachusetts.

importance in the business climate of Massachusetts as shall be elaborated upon in this paper.

Corporation

The corporation plays a very important role in the climate of the business sector of our economy. Amongst the several forms under study businessmen are usually better versed in the structural aspects and legal incidents of the corporation.

The corporation is a distinct and separate legal entity allowing the investor to insulate himself from unlimited personal liability. This form of business organization is universally statutory in the sense that its existence must be sanctioned by the State. Its internal and external relations are mostly dictated by statute. We are mainly concerned with the so-called "close corporation" which is characterized by most of the following attributes:

1. The shareholders are limited and frequently as few as one, two, or three in number.

2. The shareholders usually live in the same geographical area, know each other, and are well acquainted with each other's business acumen.

3. All or most of the shareholders actively assume most or all of the managerial functions.

4. The stock of the corporation is privately

owned without an established market for the trading of its shares.

5. The desire for delectus personae* frequently restricts the transferability of stock certificates.

In addition to the above forms we shall discuss the pseudo-corporation which is treated like a partnership for tax purposes but retains all the legal and financial incidents of a corporation.

*Delectus personae is mostly associated with the partnership form to be discussed later in the paper.

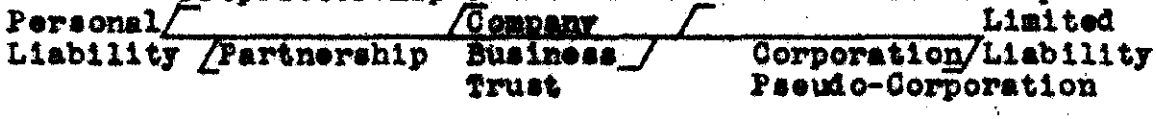
COMPARATIVE ANALYSIS OF LEGAL DETERMINANTS

Liability of the Owners

The enterprise which insulates the investor from unlimited personal liability is more attractive as a general rule than one which does not confine the investor's risk to his initial investment.

The question of the owner's personal liability for the business debts and other legal obligations must fall into one of two categories: first, the investor is individually liable for all liabilities of the business enterprise and, second, the investor is only liable to the extent of his initial investment in the enterprise.

The proprietorship is at one end of the yardstick of liability and the corporation at the other; the other business forms of organization fall somewhere in between the two. The following diagram shows the comparative degree of personal liability of the owners in relation to each of the forms under study:



The above exhibit shows the proprietorship and partnership almost equal in their respective resulting risks of personal liability. The corporation and limited partnership* offer almost complete insulation to the

*This applies to limited partners only; the general partners are still personally liable.

investor.[17] The other forms have characteristics which do and do not offer limited liability.

The importance and materiality of this factor depends on the investor's forecast as to whether substantial claims will arise against the enterprise. The likelihood of the owners in having to pay the business debts from their personal assets not originally devoted to the business has an important influence in the choice of the business form of organization. The investor who has invested his entire wealth minimizes the need of limited liability more than one who has substantial personal wealth uncommitted to the business. In addition, potential liability in the enterprise may be much heavier in relation to the proportion of capital invested. Therefore, the entrepreneur may have as his prime objective this element of limited liability. Many of the hazards involved with this factor of limited liability may be protected against through the use of insurance covering the legal consequences of tort, public liability, and workmen's compensation claims. The position of insurance as a replacement for legally created insulation from personal liability varies substantially among the different types of business. It is apparent that a small neighborhood store operating as a sole proprietorship with minimum capital outlay requires less and different insurance coverage than a close corporation employing hundreds of workers in a multi-million dollar factory.

Insurance protection is limited to the investor because of the lack of obtaining sufficient coverage as desired or because of the prohibitive cost to adequately protect against all risks involved. An ordinary loss of income because of poor judgement in business dealings or a capital loss because of a market devaluation in assets cannot usually be protected against by insurance coverage. The common risks of loss against which insurance may be purchased include loss due to death of an invaluable employee or partner, loss from fire, loss of income from rents, loss of profits due to fire, water damage, damage or loss of goods in transit, riots, civil commotions, malicious mischief, explosion, earthquake, windstorm, hailstorm, flood damage, automobile collision, fire, theft, automobile accidents, aviation, building, elevator accidents, loss of wages due to injury to employees, boiler explosions, flywheel breakage, engine breakdown, plate glass breakage, mysterious disappearance of property, defects in land titles, forgery losses, infidelity of employees, unfulfilled contracts, and credit losses are available to the owners of all the forms under study.[18] Although insurance does afford the investor a large variety of protection, the coverages do not include all of the risks to which a business is subject. Each businessman must study his particular enterprise and appropriately determine those risks which should be protected against through the use of insurance.

Legal Incidents of Limited Liability

Sole Proprietorship

In the proprietorship, the owner is subject to unlimited personal liability for all the obligations of the business and he is under a disability to limit his risk or investment to a predetermined portion of his assets. There is a complete identity of his personal wealth and his business assets. His individual creditors may levy on the assets of the business and, similarly, his business creditors may attach the owner's personal wealth in satisfaction of any lawful indebtedness. This aspect of the sole proprietorship is the disadvantage mostly disliked by entrepreneurs. In conjunction with this factor of personal liability is the possibility that the failure of the business many times may bankrupt the owner and thereby leave him unable to begin a new enterprise. Since the sole proprietorship is not a legal entity distinct from the owner, the owner is liable on all claims from the acts of himself, his agents and servants acting within the scope of their employment under the rules of agency law.[19]

General Partnership

The partnership has similar consequences as the proprietorship in relation to the liability of the owners except that the effect is in one way more limited and in

another more extensive. The risks are greater because each partner is not only liable for all the debts incurred by him in the business but he is also liable personally for all his co-partners' acts, both expressed and implied.[20] Therefore, a partner may find his personal assets available for all the debts of the firm regardless whether the indebtedness was incurred with his knowledge or in relation to his proportion in the initial capitalization. In the event that a partner must pay in full the claims of the partnership although his proportionate share in the enterprise was small, he can obtain contribution from his co-partners in proportion to their respective share of the capital.[21] Although the partner may get proportionate reimbursement from his co-partners, this right presupposes that his co-partners have sufficient personal assets and are in a solvent position in order to have the ability to contribute their respective shares to the loss. The risks are smaller since the partners must contribute their proportionate share to the entire indebtedness of the firm. Therefore, it is seen that the risks involved are proportionately greater or smaller in direct relation to the number of partners participating in the enterprise. The profits and losses are shared proportionately in relation to each partner's initial contribution to the partnership's capitalization unless otherwise agreed.

A method frequently resorted to in order to partially eliminate the individual's risk in the enterprise is to restrict each participant's authority and liability. However, this device is not binding on tort claimants or third parties without their prior notice of its terms. The only other method of limiting one's personal liability in a partnership is to become a limited partner which has other definite disadvantages the most important of which is the complete inability to participate in the management of the business.

In a bankruptcy proceeding, the firm creditors have prior claim against the firm's assets and the personal creditors have priority over their respective debtor's personal assets.[22] Unless otherwise agreed, the profits and loss are shared equally by the co-partners.[23]

The potential risk of a co-partner's unauthorized dealings is the principal factor which makes the general partnership form inappropriate for an association of strangers or for the acquisition of capital from one who will be inactive in the management. The form is a satisfactory method of doing business where the partners have mutual trust and confidence and where all participants attend to the daily affairs of the firm.

Joint-Stock Company

The joint-stock company has a similar type of

liability structure as the partnership except that the management of this form is confined to a central body elected by the members of the organization. This tempers the rule that members are personally liable for the debts of the business since the freedom of action is not present as in the partnership to bind the association. The members are not agents who may speak and act in behalf of each other and the entire business. In place of the confidence and trust of each partner in the other, the members of the joint-stock company must have a similar attitude toward the directors and officers selected by them who operate and manage the business.

By contract a joint-stock company may provide that the members be exempt from several liability of all the firm's debts. Through this method the members may limit their risk to the amount of each individual's respective share of the capital investment. The officers and directors of the joint-stock company are agents of the shareholders and not for the business. Their scope of authority may be limited in the articles of association by limiting the officers and management from binding the members personally. In order that this provision be effective, the board of directors or its agents must place on notice all persons doing business with the company that neither the managers nor shareholders shall be liable for

any debts incurred from the contractual relation. Because this restriction is not binding on third parties not having notice of its substance, the significance of the clauses tempering personal liability for the debts of the company are at best indefinite and insecure as a device which may or may not apply to each specific case.* The corporation offers greater protection with a similar internal structure and, therefore, has undermined the usefulness of the joint-stock company. The corporation has similar legal incidents as the joint-stock company with the added advantage of limited liability automatically built-in to its structure.

Limited Partnership

The limited partnership does provide limited liability but only to limited partners as distinguished from general partners. Every limited partnership must have one or more general partners who expose themselves to the same obligations as described in the general partnership.[24] The limited partner achieves limited liability in the sense that he is only liable for his initial investment in the firm; his personal assets and wealth cannot be attached in satisfaction of company debts. The form is useful as insulation only for a passive investor and not one seeking to organize and manage an enterprise. In order for the limited partner to maintain his position of limited liability he must be extremely careful not to

*It is practically impossible to give notice to an unsuspecting tort claimant.

participate in any of the management functions. The chief characteristics of limited partners which differentiate them from general partners are as follows:

1. Liability for the firm debts is limited to the initial amount of capital contributed by the limited partner.[25]

2. Withdrawal of the capital is prohibited except under specified circumstances.[26]

3. He must have absolutely no voice in the management or daily business functions of the firm.[27]

4. His interest in the partnership must be a bona fide ownership interest and not merely a loan; as such, the limited partner may be entitled to a share of the profits of the business.[28]

5. A limited partner's interest is transferable unlike the general partner's interest which may only be assigned with unanimous consent of the co-partners.[29] Upon the death or withdrawal of the limited partner, the partnership does not automatically terminate as in the case with a general partner.[30]

Unless the enabling statute of the jurisdiction is closely followed, a limited partner may lose his vital legal right of limited liability.* The limited partnership

*The Uniform Limited Partnership Act clearly expresses the restricting aspect of the formalities which must be followed. An example is Section 5(2) which imposes personal liability on the limited partner if his name appears as part of the firm's name except under certain circumstances.

is not used as frequently as it should be because businessmen are generally unaware of its operation and advantages.[31]

Business Trust

The business trust is created by agreement between the trustees and beneficiaries commonly embodied in an extensive trust instrument.[32] Limited liability in the business trust has a similar application as that expressed for the joint-stock company. The operation and management of the trust is in a board of trustees. The trustees are usually absolved of any liability for the firm's obligations if expressed in the trust agreement but, again, unless such a provision is brought to the attention of third parties, it may not protect the trustee from personal liability.* If the trustees and beneficiaries are the same, then the beneficiaries are personally liable for all legal obligations incurred in pursuance of the business.[33] In addition, the courts have held the beneficiaries personally liable as partners if their powers allowed dominion over the trustees. The business trust is not treated uniformly by the courts in the several jurisdictions which creates instability to the enterprise especially if it contemplates doing business in more than one state and when potential liability is a substantial factor.[34] Unless the trust is favorably treated by the

*A usual clause in the trust agreement is a provision securing reimbursement to the trustees in the event they are held personally liable in any of the dealings of the business.

state in which the business limits its operations, it seems advisable to form a corporation which has a uniform treatment in practically all jurisdictions.*

Corporation

Perhaps the most often cited advantage of the corporation is the factor of limited liability which insulates the stockholders from the company's debts and liabilities. The corporation is considered a distinct and separate entity which can sue and be sued. Because of this fictitious creation by our corporate laws, the stockholders obtain the safe status of limiting their personal obligations to their initial investment of capital. There are exceptions to this basic characteristic of stockholder's liability. The courts do not tolerate the fraudulent misuse of this most practical aspect of the corporate structure. The courts have frequently "pierced the corporate veil" of limited liability when there has been a complete disregard of the corporate formalities causing the corporation to neither be de facto nor de jure in existence.[35] An important factor in cases denying stockholders their defense of limited liability has been

" . . . an obvious inadequacy of capital, measured by the

*The business trust which is often cited as the Massachusetts Trust originated in this State and has since played an important role in its economy. Its usefulness shall become more apparent later in our discussion.

nature and magnitude of the corporate undertaking."[36] Where formalities are substantially observed, capitalization is reasonably adequate for the undertaking, and the corporation was not formed to evade an existing agreement or a statute to defraud, then even a controlling and, as is the case frequently, a sole stockholder can be confident of limited liability.[37] The advantage of the corporation over and above the other forms of organization is this very factor of personal liability and similar treatment in all states of the union. In addition, since the corporate form has been thoroughly tested in the courts concerning this factor, the investor has sufficient guides at his disposal to help him maintain this most realistic and practical aspect of a business enterprise.

Control and Internal Management Structure.

The provisions of control and the machinery for efficient management are important elements in any business enterprise. The control and management of the enterprise affect directly the success and failure of a business. Each investor is most anxious to know who shall control his investment and for what purpose his capital is to be expended. Because of the basic desire of each entrepreneur to protect his investment, a complete understanding of the internal structure is of utmost

importance. The investor naturally feels that his ability as a businessman is superior to that of his co-investor. His conscious desire to be in control of his own capital supports his conservative and cautionary approach to the investment. It is easier to rationalize one's failure in an investment if another was in control of the venture; however, each one feels that the failure would not have occured if he was in the position to govern the business operations.

Sole Proprietorship

The proprietor is his own boss; he is the only one in his business who has the legal right to make all decisions except to the extent that he has delegated his powers to another or has surrendered such right by contract. Most successful proprietorships require additional workers and usually others are authorized to bind the business by their decisions. In the event that the business is extensive in its operations whereby one man is incapable of handling all its affairs singularly, the proprietor must delegate some of his authority to his employees. If this is the case, the owner must realize that his employee acting within the scope of his employment has expressed and implied powers to bind the business. The proprietor is personally liable for his agent's acts[38] and the obligations derived from a single act binding upon the owner may be sufficient to permanently terminate the

company's affairs. This appears to be a basic weakness in the structure of the sole proprietorship.

General Partnership and Limited Partnership

The general rule of partnership is that each partner has an equal voice in its daily business decisions and the majority rules with the exception that unanimous consent must be given for any fundamental changes in the business unless otherwise provided by contract.* [39] Each partner has similar and concurrent powers over the partnership operations unless otherwise provided by private agreement. The partnership contract is not binding on third persons unless the latter have actual notice of its terms.** [40] Each partner is the agent of the partnership for the purposes of its business and the act of each partner is binding upon his co-partners for the apparent business functions of the firm. [41] This aspect of the partnership is both a strength and a weakness. A strength in the sense that each partner will take an active part in the operations in order to protect himself and his investment by supervising his co-partner's actions. A weakness in the sense that one partner may incur heavy losses or legal obligations without the knowledge of his

*The fundamental changes are listed elsewhere above. It is still possible that one partner may perform such functions with prior permission of his co-partners.
**The filing of the partnership agreement with the Secretary of State is not constructive knowledge of its terms binding on third persons.

co-partners. Since each partner has such extensive power to endanger the resources of his fellow owners, there must be complete confidence in all co-partners.

In absence of agreement stating otherwise, no partner without the consent of the other partners has the power to:[42]

1. Assign partnership porperty in trust for creditors.

2. Dispose of the goodwill of the business.

3. Sell at one time all the partnership's real property.[43]

4. Perform any act which would prevent the carrying on of the usual business of the partnership.

5. Confess a judgment.

6. Submit a partnership claim to arbitration.

The partnership has an inherent protective device to assure that the business remains in the same hands during its existence; this is referred to as delectus personae.[44] Delectus personae means that each partner has a veto power in his choice of his co-partners. An added investor may not enter the enterprise unless there is unanimous consent of all the existing owners.[45] This rule equally pertains to the general and limited partners in a limited partnership.[46] In a limited partnership, however, a limited partner may assign his right to share in the

capital and profits without the assent of the other participants. Nevertheless, unless there is a contrary provision in the limited partnership agreement, the new limited partner may not have the right to full disclosure of the business unless he is first accepted by all other co-partners.* [47] This feature of delectus personae protects each partner's interest and control of the business by effectively granting each the power to reject the entrance of another investor. Delectus personae is an essential feature when considered with the right of each partner to bind his co-partners, both personally and severally, by his acts.

The limited partnership has the same organizational structure as the general partnership except the limited partners are prohibited to participate in any of the management or control of the firm's business. If the limited partner does interfere with the operations of the partnership, he shall be liable as a general partner with all incidents of this status.** [48]

Joint-Stock Company

The joint-stock company is indirectly controlled

*There is a distinction between a substitute limited partner and an assignee of the limited partner's interest. The former is one who obtains all the rights of his former partner's interest which requires the unanimous consent of the co-partners and the latter is one who is entitled to the interest share and profits of his predecessor but who does not have the consent of the co-partners..

**The limited partner has the right to inspect the books and records, have an accounting, and petition the court for dissolution and winding-up of the business.

by its members and governed by a board of managers who, in turn, control officers to act in behalf of the business. The shareholders adopt by-laws in the articles of agreement which provide the internal structure of the association. The routine details of the business are under the supervision of the board of directors or managers.[49] Unless otherwise provided in the articles, the ownership shares are transferable eliminating the delectus personae present in the partnership.[50] This form of organization, therefore, has a centralized management body which performs the essential functions of the company. The board of managers are usually elected at an annual meeting of the members. This annual election gives sufficient flexibility in the operations to modify the management in the event that the members are dissatisfied with its progress. This is not present in the other forms thus far discussed under this heading. Although the corporation has a similar internal make-up which is the most feasible means of joining numerous investors together with different business philosophies, the joint-stock company is still popular when several members of one industry wish to join together to uniformly act as one in one phase of their business. An example of this is the joining of several producers of ferrous metals to purchase or sell materials related to their businesses uniformily.

Business Trust

The business trust has a permanent management not much unlike the proprietorship in the respect that once the trustees are elected they cannot be replaced by the shareholders unless otherwise provided in the trust indenture.[51] "If trustees are only managing agents, subject to the express direction and control of the shareholders (for example: the appointment or removal of officers and agents), personal liability will be imposed upon the beneficiaries as partners or principals."[52] Thus, if limited liability is of prime concern to the investors using this form of business organization, it is obviously safer that, within the terms of the trust agreement, the trustees remain largely autonomous and possibly self-perpetuating. This, of course, may be a basic weakness in this structural form. The fact that the control and management of the enterprise may not be disturbed prevents the essential flexibility often desired in the event that the owners are dissatisfied with the progress of the business.* There must be initially extreme confidence and trust in the trustee before the investor risks his capital in this form of organization.

Corporation

The business affairs of the corporation are

*If limited liability is not a controlling factor, the beneficiaries may have complete dominance over the trustees. The trustees and beneficiaries may be the same individuals and thereby overcome this undesirable feature of a separation between ownership and management.

entrusted to a board of directors elected annually by the stockholders. The board of directors in turn elect the officers and agents of the corporation annually to conduct the minor operations of the corporation. The policy governing body is the board of directors. The stockholders must be allowed to vote on the major changes contemplated by the directors.* [53] The governing structure of the corporation is fully disclosed in the enabling statutes of the states. [54] This form of management which gives centralized control to a governing board of directors is the most feasible method whereby many investors may be brought together into a single business unit without being unduly weighted down with an unruly internal organization. The common critique of the corporate form is that often the management of the business entity is separate from the ownership interests which may create a conflict in the philosophical approach of the business operations. [55] Nevertheless,

*A majority of each class of stock outstanding is required to: (a) increase or reduce the company's capital stock,
(b) change the location of the principal office,
(c) change the par value of the capital stock
(d) dissolve the corporation voluntarily.
A vote of two thirds of each class of stock outstanding and entitled to vote is required to change
(a) the corporate name,
(b) the nature of its business,
(c) the classes of its capital stock subsequently to be issued and their preferences and voting powers,
(d) any other lawful amendment or alteration in the agreement of association or articles of organization,
(e) or authorize the sale or encumbering or exchange of all the company's property and assets.

this criticism does not apply to the close corporation where the board of directors, officers, and stockholders are often the same persons. The very fact that the true interests, control, and management may be in the hands of one man who has incorporated his business does not forfeit the basic characteristics of this form.[56] The corporation must consist of at least one stockholder, three directors, and three officers.[57] Many times the company consists of dummy directors and officers in order that these formalities are satisfied with the sole investor maintaining complete control and management of the business. Another criticism is that the corporation laws do not take into consideration the superficial aspect of the so-called "incorporated proprietorship or partnership."[58] The owners of the close corporation often protect their proprietory interests by restricting the free transferability of the stock. Attached hereto is a typical stock certificate containing on its reverse side restrictions frequently employed to fulfill this need. Although the corporate form must contend with statutory formalities, there is adequate flexibility present in its structure to satisfy most of the individual's desires of management and control. Each officer may be limited in his authority and more than one officer may be required to bind the corporation. The legal relations of the corporation with others often requires separate votes of the

board of directors empowering one or more of the officers to act in behalf of the corporation before the third person will enter into a legal contract with the company. The vote of the board of directors must be attested to by the clerk or secretary of the corporation and submitted to the person contracting with the company.[59] The statutes further call for at least an annual stockholders' and directors' meetings as well as special meetings when required for the proper management of the company.

The important factors of management and control of the business is of utmost concern to the investor. The several forms of organization available to the investor today certainly give sufficient flexibility to satisfy all kinds of investors and varied circumstances. The exact nature of control and management must be custom fitted to each different business situation. The factors should be clearly decided upon prior to entering the enterprise in order to prevent internal problems that so often plague the progress of a business. The smart and concerned investor should understand fully his position and the management aspects of the business enterprise prior to obligating himself to the investment.

Financial Aspects of Control and Management

Control of the enterprise in the sense of personal domination is not wholly a function of form as

it is a function of finance and personality.[60] If the organization is properly developed, the one who has financial control in the sense of furnishing all or most of the capital may retain the working control of the business. This same principle pertains to one whose ability, personality, and experience are such as to acquire the respect and confidence of others so they trust him with the control and operations of the business venture. The choice presented to the entrepreneur is to either grant a proprietory interest to others with the right to share in the profits and management or, instead, to allow the presence of a debt interest together with contractual obligations which becomes a fixed expense to the firm. The debt interest may restrict the conduct of the business and its future financial condition. In the event the proprietory interest is elected, it must then be decided whether the equity capital should be coming from a few or many persons. If there are a few investors, any of the forms discussed may be the choice form. If there are numerous divided interests, a form with a centralized management may be best in order to facilitate the bringing together of many personalities without the attendant difficulties as to the complexities of ideas and management control. The most popular and likely form to be chosen in such an example is the corporation which may be so devised as to attract the necessary

capital and, at the same time, reserve control and majority management in the entrepreneur.* This may be accomplished at the inception of the enterprise when dummy incorporators may be used to form the corporation with the attendent choice of the board of directors and officers. Provisions are adopted to provide for the possible public sale of the stock and reserving to the promoter a favorable position of control.

One of the methods that may be employed to accomplish this end is the initial authorization of one or more classes of stock such as common (voting) and preferred (non-voting) shares. The corporation thereupon issues the common shares immediately and reserves the preferred shares for subsequent equity financing.**[61] Preferred stocks are a prevalent form of ownership interests which typically are entitled to priority of the available earnings before the common stock is entitled to dividends, and, in the case of liquidation, this superior stock must first be paid a limited amount out of the assets before the common stock receives anything.[62] In addition, there

*The business trust, limited partnership, and joint-stock company contain the necessary characteristics to also satisfy this proposition. The lack of investors' attraction to these forms in comparison to the corporation is apparent from the popularity of the latter's common use.

**Authorizing stock is a preliminary procedure to its issuance. Authorization is the formal filing in the articles of organization with the state setting forth the essential characteristics of each class of stock. Issuance is the actual offer to sell the shares representing the ownership interests in the corporation.

are many different restrictions that may be used in the issuance of a preferred stock or, for that matter, any class of stock. The preferred stock, for instance, may be either participating or non-participating, cumulative or non-cumulative, voting or non-voting, restrictive or non-restrictive in its transferability, callable or non-callable, convertible or non-convertible.*[63] This exemplifies the flexibility available to the corporation of equity financing and, at the same time, the available methods which the owners may employ to retain control and management of the business.

Several devices aside from the classification of stock are available to the promoters of the corporation in order to preserve their control and management. They are as follows:

Cumulative voting of the stock:[64] This device allows each stockholder to increase his votes by a multiple of the number of directors elected. If three directors are to be elected, five shares of voting stock could under this method cast fifteen votes for one or more of the directors instead of five votes for all three. This allows the minority interest to elect a larger proportion

*It is not the purpose of this study to elucidate on each characteristic as listed. The purpose is to bring attention to the flexibility provided by this form of entity in its equity financing features. The references as listed in the bibliography give an exemplification of the different devices available including the issuance of bonds, a form of debt financing.

of the board of directors by a careful bunching of votes.

Proxies:[65] This is a revocable (by death or wish of the stockholder unless coupled with an interest) device whereby the stockholder assigns to another the voting powers of his shares. This method is often restricted by statute to a relatively short duration.

Voting trust:[66] This is usually a statutory controlled method whereby stockholders transfer to a trustee legal title to their shares retaining equitable title in themselves. The trustee, in turn, exercises dominion over the voting rights of the stock and the stockholders receive voting trust certificates evidencing their transfer.

Shareholders may privately agree to give effective control for an indefinite time to one person in the voting rights of the shares.[67] Many states frown upon this method and, therefore, the agreement must be strictly drafted according to the laws of the particular jurisdiction.

The above methods help to centralize control of corporate management and insure continuity of management policy.

One should not get the impression that the form of organization by itself is the decisive factor in the question of control. Frequently the banks place the enterprise in such a position that restrictions are imposed on the business operations during the time the outstanding

indebtedness of the enterprise remains unpaid as set forth by the terms of the loan contract. One man who does not have a proprietory interest in the business may, nevertheless, control and manage the operations because of his experience and the faith he has instilled in the owners. A partner may have less say than what may appear in the partnership agreement because of the practical and operational aspects of the business. He may find that he has only a minority voice and not an "equal" voice in the decisions of the business.

The businessman may maintain and control his proprietory interest in the venture and, at the same time, retain complete management of its operations by incorporating at its inception provisions securing this status for himself. He should fully undertake the business with full knowledge of the pitfalls prevalent in each form of business organization and attempt to use that form where his desired objectives are firmly entrenched in the structure of the enterprise.

COST AND CONVENIENCE OF DOING BUSINESS

By definition, the most efficient form of organization for doing business is ultimately the cheapest; however, this is not necessarily the case at all times. The cost expended to qualify a business is usually very small in comparison to the total capitalization of the enterprise. In fact, rarely are the expenses to formalize a small business more than nominal. The more formalized the business becomes, the more expensive it is to maintain its legal structure. This is clearly exemplified in the expenses incurred as we go progressively from the least complex to the more complicated forms which require more formalities in their creation. The same proposition is true as to the convenience of doing business if we limit the definition of convenience to its more narrow meaning of legal simplicity and absence of formality.[68] The costs usually incurred to create one of the several entities are the fees, incidental taxes (other than federal), and the cost of legally requisite formalities. In the proprietorship, there are usually no formalities and, therefore, there are none of the usual expenses which are often imposed on the other forms of business organization. In the partnership, if there is a written contract of partnership and if it is filed with the state or city, there are such

costs as attorney's fees and filing fees which are usually very nominal.* The limited partnership agreement must be filed with the state which requires the services of an attorney in order that care is taken to retain the essential characteristics of the form.[69] The corporation (business trust and joint-stock company as well if formalized) must pay an organizational tax, fee for filing the articles of organization, recording fees, an annual franchise tax, a federal stamp tax on the issuance and transfer of stocks, and the filing of an annual report called a certificate of condition.[70] In addition, each corporation must make annual reports to the stockholders, must keep a minute book of all meetings of the stockholders and board of directors, must pay additional fees in order to amen the by-laws or any other part of the corporate records and to increase the capital stock not already authorized.[71] Depending upon the circumstances of each case, the additional costs incurred to develop the corporate form of organization may be insignificant in relation to the advantages derived therefrom.

The convenience of doing business involves such elements as qualifying the business in foreign states, flexibility of movement, legal freedoms, and internal management requirements. The proprietorship's assets,

*Also usually the filing in the city hall of a business certificate.

both real and personal, are in the name of the owner and he may dispose of them as he wishes without further ado. The partnership owns real estate as a tenancy of partnership but all partners must be joined and named individually when the partnership sues or is sued.[72] The partnership, like the proprietorship, is free to do business in any state without qualifying, and its records and other internal functions do not have to be published or disclosed to the public. The corporation has to first qualify by fulfilling all the technical requirements as set forth in the enabling statute of each state before it may do business within its borders.[73] Furthermore, it must file annually certain information about the business which is open to public inspection.*[74] Many of the decisions must go through the heirarchy of command before the corporation is empowered to act and legally bind the company in its business dealings. The joint-stock company may have the same restrictions imposed on it as the corporation if the state in which it does business has an enabling statute; otherwise, it may operate with the same freedoms as described for the partnership.[75] The business trust

*This one factor may discourage the use of this form. Of the many idiosyncrasies usually found in businessmen, the disclosure of their personal or business wealth is perhaps the most jealously guarded. Furthermore, the public disclosure of a firm's wealth more easily exposes the company's assets and its ownership shares to attachment in conjunction with litigation.

need not be restricted to the extent of the corporation. In relation to the convenience of the business trust in doing business, it is not the fact that it must fulfill certain requirements as much as it is the indefiniteness of legal treatment extended to this particular form by many jurisdictions.[76]

These factors of convenience and cost of doing business are basically unimportant to the small investor. Because the business is usually functioning as a proprietorship or partnership in reality regardless of the form and formality required by law, the convenience of doing its daily business is not an important determinant since many of the formal requirements causing the inconvenience of operation are usually delegated to the lawyer or other skilled personnel. The additional costs attendent with the more complex forms are relatively unimportant when viewed as a whole operating unit. In other words, the increased inconvenience or costs are not a sufficient deterrent by themselves to prevent the investor to utilize the more expensive forms of organization.

LONGEVITY OF ORGANIZATION

The corporation, joint-stock company, and business trust may continue in existence indefinitely.* The change in ownership interests, management and other elements of the original business will not by itself terminate the organization's life. This is not the case with the sole proprietorship, general partnership, or limited partnership.

Sole Proprietorship

The proprietorship is automatically terminated upon the retirement of the owner regardless if it is caused by death, sickness, incapacity, or voluntary withdrawal. As is the case in any form of organization, the paramount practical problem of succession is the replacement of managerial talent. In the sole proprietorship, this frequently requires a change in the form of doing business in order to permit the original proprietor or his estate to retain an interest in the business when management passes to another, whether heir or stranger.** The retention of a proprietory interest in the business must, by definition, mean that another form of organization has

*In Massachusetts, a real estate corporation may only exist for no more than 50 years. A business trust is limited in duration by the Rule Against Perpetuities which limits life to two beings in existence plus 21 years.

**This aspect of the discussion will be more fully treated in the estate planning section of the paper.

been formed when part of it is conveyed or devised to another.

At the outset of the enterprise, the planning for continuity is more serious for the partnership and close corporation than the other forms.

Partnership

The general rule that a partnership is automatically dissolved upon the death or withdrawal of any partner may be contravened by agreement of the co-partners.[77] Because of the many difficulties that arise upon the death or withdrawal of a partner, it is extremely advisable that a written contract of partnership is originally executed containing all the possible elements of contention that may arise amongst the parties. This allows in advance the procedure or solution to be used in such event. One of the most serious problems encountered is the valuation of the withdrawing partner's share in the business. According to law, each partner has an undivided proportionate interest in the partnership assets dependent upon the initial capital contribution of each.[78] The valuation of such intangible assets as good-will and potential profits are the "sore spot" of contention. Provisions relating to the evaluation of each partner's interest by submission to arbitration or the application of a formula relieves the parties of potential trouble and possible litigation. In addition, the method of payment is equally as important in order

not to create a strain on the business's resources and liquidity. Some common provisions for the fixing of value are book value, independent appraisal, periodic determination by all the partners, and arbitration.[79] Payment may be provided for by fixed installments over time, by a share in the profits, or by proceeds of cross life insurance policies.*

Corporation**

In a corporation when the shares are freely transferable, the problem of withdrawing from the enterprise is facilitated especially if there is a ready market for the shares. However, alike the partnership, the close corporation does not have the guide of value from a market in the shares because of the usual restrictions that are placed on the transferability of the stock in order to retain some of the delectus personae as existent in the partnership. Thus, the valuation and payment of a shareholder's interest in the close corporation is as troublesome as in the partnership except that the continuity of the business is not endangered to the same extent. The close corporation may be endangered as to retaining its continuous life if the payment of a withdrawing stockholder's shares will leave the business

*The tax consequences may affect the decision of payment considerably.
**This discussion of the corporation also applies to the joint-stock company and business trust.

drained of the necessary working capital to continue its business. This problem is not a legal matter as much as a financial and practical problem of survival.[80]

The legal machinery of continuous existence is automatically present in the corporation while such longevity must be voluntarily created in the partnership. Consequently, if the investor intends to temporarily maintain his investment in the enterprise with the expectation of withdrawing within a limited time period, the corporation certainly affords the better investment without a consequential upheaval in the organization. The investors of a business are usually so concerned with the doing phase of the enterprise that they often neglect or provide for the possibility of co-ordinating and planning for the many fringe aspects of the business such as the unforseen consequences from the withdrawal of the stockholder-manager or partner. This problem shall be further discussed under the heading of estate planning and tax incidents of the paper.

FINANCIAL ASPECTS OF FORM

The adaptation of each form in obtaining the necessary capital requirements of the business is of prime importance to the success or failure of the enterprise. The life blood of every business is the adequacy of working capital. Unless there is sufficient liquidity in the enterprise, the business gradually chokes itself to death. The important balance of fixed and variable expenses play heavily in this aspect of the business. Therefore, the entrepreneur should first estimate the immediate and future capital needs of the business. One who can supply all the capital requirements from his own wealth does not have the element of finance to influence his choice of business form. In contrast, the choice of business form of organization is greatly influenced by the financial needs of the enterprise in the event that sufficient capital must be raised from outside sources. If further capital is required, the questions of how much, how soon, and in what form must be assessed. The greater amount of capital to be raised from outside the initial investors of the business, the more frequently equity rather than debt financing must be resorted to by necessity.[81]

Usually the less assets and the lower earnings there are in the business, the greater security and higher return is expected from the lender or investor in the enterprise. The security offered is in direct proportion

to the returns expected by the lender or investor. The higher the debt financing of the firm in relation to the equity capital, the more onerous and expensive are the contractual restrictions imposed on the borrower.[82]* In the event that the investor feels his business must subject itself to undesirable fixed charges and unhealthy restrictions in order to obtain the necessary capital requirements through debt financing, then, from the standpoint of retention of control and security from financial burdens, the more equity investors the better.

Sole Proprietorship

The financial flexibility of each form varies considerably. The available financial means of acquiring equity and debt capital in the proprietorship varies in a large degree from that of the corporation. Equity financing is impossible for the sole proprietorship. By definition, the proprietor is the sole owner of his business and, in the event that he does sell part of his proprietory interest in the business, it is no longer a sole proprietorship. Thus, the sole proprietor is limited to debt financing and this means private borrowing, secured or unsecured, on such terms as he may negotiate. Aside from friends, relatives, trade creditors

*Many firms borrow capital to obtain leverage and thereby obtain higher earnings. However, leverage may also work against the company by increasing losses if incurred.

on open account, factoring companies, the proprietor is limited to his banker for the necessary funds. Unless he is able to prove his ability as a businessman or has reasonable assets in relation to his loan, the proprietor shall have trouble obtaining the necessary funds from the available sources.

General Partnership

The partnership is not as limited in sources of capital as the proprietorship but, as a practical matter, it must rely more heavily on debt financing than on equity financing. The only way the general partnership may obtain equity financing is to allow the investor to enter the company as a general partner with ownership in proportion to his contribution. This may not be desirable to the investor nor to the co-partners. The entrance of an additional partner involves more than the use of the capital contributed. The intangible elements of personality, internal control, and personal liability all must be considered by both the partnership and the investor before the manifestation of assent is finally expressed. In addition, the more partners there are the more organizational and related difficulties arise which may result in internal dissension. The added numbers of owners may also become an "association" for tax purposes and thereby have imposed on the firm similar tax incidents as the corporation. Therefore, the available

sources of raising equity capital in the partnership is extremely limited or undesirable since part control of the enterprise must be given up.

Limited Partnership

The limited partnership allows equity financing without the onerous factors above described in the general partnership. The very creation and operation of the limited partnership was specifically organized in order to overcome the difficulties usually encountered by the general partnership in its obtaining additional equity capital. However, the structure required by the statutes in order to retain the limited liability of the limited partner is often the barrier in the attraction of investors. This, together with the absolute release of all control of the limited partner's investment in the hands of the general partners, makes this form for equity financing unattractive to the common investor.[84] Nevertheless, this device has been popular in recent years as the structure for the syndication of real estate holdings whereby the public have been offered ownership shares of large real estate holdings as limited partners in return for expected large distributions of the net income and depreciation allowances under the federal tax laws.*

*It should here be noted that the promoters have to offer greater returns to the investors in this type of business form in order to attract the investment. A recent amendment of the Internal Revenue Code enacted as Sections 856-58 of 1960 has formed the Real Estate Investment Trust with tax benefits expecting to replace the limited partnership form in this field of investment.

Corporation, Joint-Stock Company, and Business Trust

The corporation offers the most abundant opportunity and possibility in obtaining equity financing. The infinite variations in the corporation's capital structure under the common enabling statute permit accomodation of virtually any and all requirements to satisfy both the investor and the organization. However, in many close corporations, investors ready and willing to buy the issued stock of the company may not necessarily be available to each and every business venture. Unless the corporation has an adequate earning record and has proven itself a stable and relatively successful business, the equity capital available to the promoters may be much less than needed. In addition, the debt financing is usually no better than that of the partnership or proprietorship unless the corporation has sufficient collateral to secure the loanable funds. It is not infrequent that the bank requires the personal guarantee of the stockholders-directors thereby defeating the limited liability of the investors.[85] Thus, up to a certain point of financial dependence, the corporation does not necessarily offer more advantages than the partnership; however, after the business has been in existence for a reasonably long time and has been successful in its operations, the corporation definitely affords the management a much better

vehicle by which to raise additional equity capital and debt financing. The investor is more anxious to protect his personal assets when he invests in a business without the accompanying control of the capital and, therefore, the corporation grants this immunity by offering the investor limited liability.

The joint-stock company and the business trust may offer the same advantage of limited liability but, because of the lack of uniformity in the treatment of these forms by the states and because of the ignorance of their operation by the layman, the two business forms are not as popular to the prospective investor. Although the corporation has been probably the most successful form in which to raise the necessary finances of the business, there is sufficient empirical evidence to show that the unincorporated forms of organization have not been lacking in either adequate financing nor in the lack of available funds.[86]

> There have been misconceptions concerning small business financing problems which are not founded in fact. These views are significant because they have influenced both private and public policy toward small business. They have led to the incorrect view that small business is weak, unprofitable, and lacking access to capital funds. Small business undoubtedly has problems, some of which may require outside aid. The strength and economic soundness of small business in the generally prosperous postwar years have been seriously underestimated. Small business has demanded, obtained, and made profitable use of the whole

or more than fifty billion of loan and equity capital. It is indeed astonishing that there has been so little recognition of the vigor and flexibility of small business and of the tremendous volume of capital which it has utilized successfully in the postwar period.

TAXATION

In our contemporary society, the government has become an investor in each and every form of organization. The government is an investor in the sense that it imposes a tax on the income of each business and, therefore, each year is entitled to its proportionate return of the company's earnings. An example of this is the assessment of a corporate tax on the adjusted taxable income of 52% on each dollar earned after the first $25,000.**The corporation is paying to the federal government a little more than one-half of its earnings; for each six day week of operations, the company is, figuratively speaking, working for the government slightly more than three of the days. It is commonly agreed, therefore, that more times than not this silent investor is unwanted and that its share of the profits should at all times be minimized.*

In the determination of the form of business organization, tax minimization is one of the basic considerations to be analyzed. Precaution should be taken not to allow the tax consequences of any one form influence the choice completely without first being cognizant of the other factors which may be more influencial in the eventual

*This is to say that the avoidance of the tax consequences is a permissible activity in our society; the evasion of taxes is not.
**See tax schedules comparing the tax incidents of the corporation and individual further in the discussion.

success or failure of the business. At the same time, taxes may weigh so heavily on the scales in the circumstances studied that this one factor may overbalance in importance a number of other considerations. An example of this is the possibility that the firm may qualify as a personal holding company with its attendent tax disadvantages.*[87]

Taxes incidental to the organization are greater for the corporation than for the other types of businesses. Numerous studies have shown with striking unanimity that of recent years, and when both Federal and State levies are considered, a substantial and increasing toll is paid for the corporate privileges and advantages.[88] Although organizational fees, franchise taxes, stock transfer levies, and state taxes may be burdensome, their imposition is usually not sufficiently great to be an important determinant in the choice of a business form.**[89] An example of when state taxes may be a main determinant in the choice of organization is the imposition of Massachusetts tax laws on the corporation in comparison with the business trust if the business is one of real estate. The corporation must pay a corporate excise tax which is a combination of the income and property tax. The income tax is 5⅛% plus 23% surtax or an effective rate of 6.765%

*See Appendix for definition of a personal holding company.
**See Appendix for the state tax levies on filing fees and federal levies on stock transfers.

and is similarly imposed as the federal income tax.[90] The property tax is an assessment on the fair value of the capital stock at a rate of $5 per $1,000 of valuation plus 2½% surtax; it may be levied regardless if the corporation has net income.[91] In comparison, the business trust is not treated as a corporation under Massachusetts tax law and, therefore, the corporate excise tax is inapplicable.[92] In fact, the business trust under Massachusetts laws is treated similarly as the general partnership under Federal tax laws; it is a mere conduit between its owners and the taxes assessed against it.[93] Thus, a business trust is not taxed on rental income as a corporation and, therefore, is not subject to double taxation in the State of Massachusetts.

The Internal Revenue Code has classified each of the taxable forms of business organization under one of three main headings: individual (sole proprietorship), partnership (general partnership and limited partnership), and association (corporation, business trust, and joint-stock company).[94] The income tax incidents are similar for the individual and partnership. The association has a separate and distinct tax structure which may result in advantages or disadvantages for the investor. An association is a separate taxable entity which must have most of the following attributes:[95]

1. Limited liability of participants;
2. Centralized management;*[96]
3. Transferability of ownership interests;
4. Continuity of existence.**[97]

The main distinction to be here discussed is the tax consequences between the general partnership and the corporation; examples of the two basic tax entities as are presently applicable under the Internal Revenue Code of the Federal Government. Whatever is said in behalf of the corporate tax structure pertains equally to the joint-stock company and business trust. The general partnership includes the same tax incidents as the sole proprietorship and limited partnership.***[98]

Partnership vs. Corporation

The income of the partnership is taxed directly to the owners of the business. The income of the corporation is taxed to the corporation which is a separate and distinct taxable entity from its stockholders. Regardless if the partnership's earnings are retained or immediately distributed, each partner must report annually in his respective income tax return his entire portion of the firm's earnings.[99] The stockholder is not taxed on his

*A joint-stock company is taxed as an association; therefore limited liability is not a sine qua non for this classification.
**An association is an organization which continues regardless whether its ownership changes or the affairs are conducted by one or more individuals.
***Under certain circumstances, the limited partnership may be taxed as an association if it satisfies most of the definition's characteristics.

proportion of the corporation's earnings until distributed to him in the form of dividends or salaries. The stockholder need only report his actual cash receipts from the corporation in his annual income tax return. Such receipts are ordinary income to the receipient and the tax rates applicable to individuals are assessed on these distributions after allowance for the annual dividend exclusion and payment credit.[100] The corporation's income is first taxed to the company and then taxed again when it is distributed in the form of dividends.* Nevertheless, this form of "double" taxation does not usually penalize the shareholders of a close corporation because most of the corporate income is withdrawn in the form of salaries by the shareholder-employee which are deductible business expenses of the corporation. It is possible to compare the resulting tax liabilities of the individual under the two forms of doing business, the corporation and partnership. The maximum income tax payable by a corporation is less than the highest tax rates assessed to an individual.[101]** The tax rates applicable to the individual vary according to his marital or head of a household

*The tax laws slightly reduce the effect of double taxation by allowing the taxpayer a deduction for the first $50 of dividends received in a taxable year and a dividends received credit equal to 4% of all dividends received above $50.

**The corporation pays 30% on the first $25,000 of net earnings and an additional surtax of 22% for all amounts above, a maximum tax of 52%. The individual rates start at 20% on the first $2,000 earned and progressively climb as high as 91% of his taxable income.

status. The progressive income tax applicable to the individual begins to take its effect at a lower income bracket than that of the corporation. For instance, the individual must pay a tax between 43%-59% on his earnings of $25,000 while the corporation pays a maximum of 30% on its first $25,000 earnings.*[102] These figures exemplify the feasibility of using separate taxed entities to obtain tax savings after one has reached a certain amount of taxable income. This is often referred to as "tax splitting". Unless a married taxpayer has taxable income of at least $16,000, or a single taxpayer income of $8,000, or a head of a household income of $10,000, the benefit derived from the use of a corporation as a separate tax paying entity will not be realized. Although theoretically this method of splitting income between the individual and a corporation is advantageous at any income higher than the amounts above stated, practical considerations will make it inadvisable to use the corporate form unless the income level is reasonably above these breakeven points. The underlined figures on the following chart represent the breakeven points where the corporation begins to offer tax benefits. The corporate form, as can be seen on the chart, will even save the taxpayer money although retained corporate earnings are subject to an additional capital gains tax when eventually withdrawn.

*These percentages by themselves are often misleading since the particular circumstances of the corporation and the individual may greatly modify the tax results.

Comparison of Federal Taxes by Operating as a Corporation vs. an Unincorporated Business or Pseudo-Corporation

Married Person with Wife And One Child*

Operating As Proprietorship or Pseudo-Corporation		Operating as Corporation		Tax Saving (or loss) as Corporation	
Net Business Income	Tax	Assumed Salary	Total Income on Individual and Corporation	Assuming no double tax	Assuming Capital Gain on Retained Earnings
$ 19,000**	$ 3,988	$12,000	$ 4,092	$ (104)	$ (1,329)
20,000	4,328	12,000	4,392	(64)	(1,464)
22,000	5,008	14,000	4,912	96	(1,304)
26,000	6,496	16,000	6,080	416	(1,334)
32,000	9,084	18,000	7,880	1,204	(1,246)
38,000	12,000	20,000	9,728	2,272	(878)
44,000	15,192	20,000	11,528	3,664	(536)
50,000	18,648	20,000	14,428	4,220	(755)
60,000	24,702	22,000	19,268	5,436	(499)
70,000	31,000	26,000	23,876	7,124	469
80,000	37,548	28,000	28,856	8,692	1,077
90,000	44,448	32,000	33,744	10,704	2,369
100,000	51,624	38,000	38,740	12,884	4,069
150,000	90,072	44,000	64,812	25,260	11,165
200,000	132,204	50,000	91,148	41,056	21,681

Single Person With Two Dependents*

$ 11,000**	$ 2,028	8,000	2,104	$ (76)	$ (601)
14,000	3,096	10,000	2,920	176	(524)
18,000	4,824	10,000	4,120	1,032	(696)
20,000	5,800	12,000	4,768	1,468	(282)
26,000	9,088	12,000	6,568	2,520	70
32,000	12,724	14,000	8,496	4,228	1,078
50,000	24,804	18,000	15,964	8,840	3,625
70,000	39,936	22,000	26,296	13,640	6,505
100,000	64,884	38,000	43,280	21,604	12,789
150,000	109,328	44,000	70,188	39,140	25,045

*Figures are based on the 1958 tax rates (1960 rates substantially the same) and assuming (a) no dividend payments, (b) salary payments from corporation as listed here, (c) no other source of income, (d) the optional standard deduction is used.

**No tax saving can result from the use of the corporate form where the married person's income is less than $19,000 or the single person's income is less than $11,000.

Source: Tax Institute, Inc., Partnership or Corporation.

This saving is present if a married man has taxable income over $32,000, a single person over $16,000, and a head of a household over $22,000, and each incorporates to avoid higher personal tax payments.* This saving is based on the fact that the first $25,000 of corporate income is taxed at 30%, and 25% capital gains tax is assessed when the remainder is withdrawn. Thus, there is an overall tax rate of 47.5% which is below the top surtax bracket for individuals with income over the specific breakpoints. These tax benefits as above outlined become progressively more apparent as the taxpayer's income increases. If there were no other factors affecting the applicability of the corporate form which shall become apparent in the following discussion, it would always be advisable to incorporate a business wherever an individual's income (after deductions and exemptions) falls into a tax bracket higher than the minimum corporate rate of 30% ($8,000 for a single person, $16,000 for a married man, and $10,000 for head of a household).

Salaries of the stockholder-employee withdrawn from the corporation must be reasonable and in proportion to the actual services rendered.[103] Because the salary of an employee with a proprietory interest in the company is closely scrutinized by the government, it must be paid

*This assumes that all income earned above these levels is by the corporation.

during the good as well as the bad years. If the salary fluctuates in direct proportion to the earnings of the corporation, it is an apparent signal that the compensation is not given in behalf of services rendered as much as for the purpose of avoiding tax consequences.[104] The reasonableness of a particular salary depends on the difficulties, importance and responsibility of the job; the time and effort spent on the work; and the special training and experience essential to accomplish the duties. The volume of the business, amount of profits and of capital employed are also factors affecting a permissible salary. A salary comparable to that paid for a similar job in a related business will generally be approved; however, it is often difficult to obtain such information from competitors.[105] The penalty imposed in the event that part of a salary is not allowed because of its unreasonableness is the loss to the corporation of a deductible expense with the employee still being fully taxed on such amount. Thus, the payment of an unreasonable salary to a stockholder-employee results in a double penalty- a non-deductible expense to the corporation and a tax to the employee. The following table shows salaries that will give the least over-all tax burden at various levels of business income. The table is a useful guide to show the relation of salary to income but it does not

take into consideration the reasonableness of the salary to the services rendered by the recipient.

"Best" Salary From Corporate Income
(Based on '58 Tax Rates)*
(Assuming stockholder-employee's outside income equals deductions and exemptions)

Corporate income before salary	Married Man	Head of Household	Single Man
$ 10,000	$ 10,000	$ 10,000	$ 8,000
15,000	15,000	10,000	8,000
20,000	16,000	10,000	8,000
25,000	16,000	10,000	8,000
30,000	16,000	10,000	8,000
40,000	16,000	15,000	15,000
50,000	25,000	25,000	18,000
60,000	35,000	28,000	18,000
70,000	36,000	28,000	18,000
80,000	36,000	28,000	18,000
90,000	36,000	28,000	18,000

Source: Tax Institute, Inc., Partnership or Corporation.

From the above chart, it is seen that the most economical salary from a tax standpoint for a married sole stockholder is $25,000 when the corporation's earnings are $50,000. The salary deduction of $25,000 for the corporation saves taxes at a rate of 52%, or $13,000. The employee is taxed $7,230 on his salary of $25,000. Any further increase in salary to the employee would be uneconomical since the tax saving to the corporation would be only 30% while the tax cost to the recipient would be 43%. Similarly, any decrease in salary would cost the corporation 52% to save the stockholder 43%.

*The 1960 tax rates are the same as the 1958 rates for both corporations and individuals.

The assessment of a double tax on corporate earnings, first when they are received in the company's treasury and second when they are distributed to the stockholder unless given in the form of salary, has stimulated the private sector of the economy to develop devious methods of tax avoidance. The loopholes which have developed in the tax laws have been gradually plugged-up by applicable governmental regulations. An example of this is the so-called "collapsible" corporation. A "collapsible" corporation is defined as a corporation purposely formed or availed of to manufacture, construct, or produce property for the principal purpose of granting its stockholders a realization of capital gain which is attributable to such property through the means of selling their stock or liquidating the corporation prior to the realization by the corporation of a substantial part of the net income to be derived from such property.[106] This device of obtaining the lower rates applicable to capital gains, 25% of the amount above the cost basis of the property, instead of paying the higher rates resulting in ordinary income and from the double tax imposed on the corporate income is not tolerated by the government and is accordingly treated as a sham.[107]

Another example of the taxpayer's attempt to avoid the double tax imposed on the corporation's earnings

is the method called "thin" capitalization.[108] This is a device whereby the corporation has an excessive debt structure in order to obtain a deduction for interest payments made to the holders of the indebtedness. This method usually involves a minimization of the initial capitalization of the company for the sole purpose of tax avoidance and, at the same time, allow the incorporators to withdraw their investment without the need of dividends. The tax authorities recognize interest payments as a legitimate deduction if the loan was bona fide and not actually a contribution to capital. Although there is no set ratio of how much debt financing to equity financing will be allowed for tax purposes since each situation is looked at separately, under general circumstances the ratio of three dollars of debt to every dollar of capitalization is usually permitted by the Federal Government under the income tax laws.

The government has recognized the difficulties imposed on the business organizations and, therefore, has now given most taxable forms the option to elect different taxable incidents than originally imposed on their respective earnings.

An unincorporated business (sole proprietorship or partnership) may elect to be taxed as a corporation.[109] Personal holding company income now is taxable directly

to the individuals and not to the business entity as a corporation; however, the principals do not become eligible to participate in a qualified pension or profit-sharing plan. This privilege of election to be taxed as a corporation is available only if the enterprise satisfies all of the following conditions:[110]

(a) The enterprise is owned by an individual or a partnership with a maximum of fifty individual members;

(b) No proprietor or partner having more than a 10% interest is also an owner of more than a 10% interest in any other unincorporated business enterprise taxable as a domestic corporation;

(c) No proprietor or partner is a nonresident alien; and

(d) The enterprise is one in which capital is a material income-producing factor of 50% or more of the gross income and consists of gains, profits, or income from trading as a principal or as a broker.*

If the enterprise is a partnership, all partners must consent in the election. This offers each partner an important veto power. Once the election is made it is

*This qualification rules out firms engaged in professional services (e.g. law, accounting) and in many other personal services. However, it is possible to draw up a partnership agreement so that it is a partnership for state and local purposes but, nevertheless, qualifies as a corporation for federal income tax purposes. If this is done, the partner-owners are then employees for tax purposes and can be covered by an approved pension and profit-sharing trust.

irrevocable until the interests of the electing proprietor or partners are reduced to 80% or less.

An important advantage in being taxed as a corporation is the ability to retain earnings without immediate taxable consequences. Thus, if a partnership of professional men wish to accumulate earnings and thereby avoid excessive personal income taxes by splitting their personal and partnership income, this election, if permissible under the particular circumstances, will be an advantage. The retained earnings in the business will not be taxed to the owners until withdrawn in later years when the income tax brackets of the partners will most likely be lower.

In the corporation, the shareholder is unable to take his business losses as the partner until he sells his shares, the corporation is liquidated, or his stock otherwise becomes worthless.[111] In comparison, the partner may deduct his proportionate share of partnership losses in the year that such losses are incurred.[112]

In the corporation, the business is able to accumulate up to $100,000 of its income without being penalized for undistributed profits.[113] If the corporation does accumulate additional net earnings without justifying such action, it will have to pay a penalty for unjustifiably withholding distribution of profits.[114]

There is an accumulated earnings penalty tax of 27½% on the first $100,000 and 38½% on any amount thereafter in excess of the real needs of the corporation. The purpose of the corporation to retain earnings is mainly to save the stockholders from paying an income tax on a dividends distribution. The first $100,000 retained earnings exclusion will be taken into account in the determination of whether excess accumulations are unreasonable.[115] The following are legitimate reasons for the accumulation of earnings over and above the excluded amount of the first $100,000:[116]

To finance additional business
To procure additional real property for business
To liquidate mortgages or other long term indebtedness
To acquire more machinery and equipment
To replace antiquated equipment
To pay dismissal wages to employees
To develop new processes, items, and markets
To improve the financial condition of the company
To expand business by buying out concessionaires
To build investments and inventory
To provide adequate working capital
To make up for inventory shortages caused by defense conditions
To provide reserve for expansion (this must be more than a nebulous hope)
To buy life insurance on key employees

Therefore, no dividends need be declared so long as funds are retained for the reasonable current and future needs of the business. It is only where the business begins to use its funds in a manner inconsistent with normal business practice that the danger of the penalty tax

arises. In most cases the regular income tax plus the penalty tax for unreasonable accumulations will be prohibitively expensive to leave income in the corporation. However, if the individual is in a high enough tax bracket, the payment of the regular tax plus the penalty tax can still be lower than what he would have to pay if the income were all taxed to him. The chart following on the next page gives an example of the computation displaying the savings realized after the assessment of the penalty tax when the stockholder-employee withdraws the entire earnings of the corporation less the first $100,000 exemption. The unreasonable accumulation of earnings should not affect a new corporation for several years because of the $100,000 exemption. In addition, the incorporation of an existing unincorporated business may be so formed as to be undercapitalized at its inception in order to delay the assessment of the penalty tax. In comparison, the partnership and pseudo-corporation can accumulate its earnings without any tax problems because its income is taxed directly to its owners and shareholders whether distributed or not. Another method of avoiding the penalty tax for unreasonable accumulations is to elect to be taxed as a pseudo-corporation when the time comes that this tax may be imposed on the corporation. The pseudo-corporation is discussed fully later on in this paper.

Corporate Income of $500,000 After All Expenses And Deductions But Before Salary Based on Tax Rates In Effect For Fiscal Year Ending July 1, 1961 And Assuming Only One Stockholder-Employee With A Salary of $100,000 With No Other Outside Income Except To Exactly Offset All Allowed Exemptions and Deductions.

Normal Tax On Corporate Earnings of $400,000 After Deducting Salary of $100,000 From Gross Income of $500,000	Penalty Tax On $110,500 After Deducting Earnings And Taxes*	Total Taxes On Earnings And Penalty Taxes
$189,500.00	$ 31,542.50	$221,042.50

Tax To Single Stockholder On $100,000 Salary	Single Taxpayer	Married Taxpayer	Head of House-Hold Taxpayer
	$ 67,320.00	$ 53,640.00	$ 60,480.00
Tax If Distribution of All Corporate Income to Sole Stockholder Less First $100,000 Earnings Retained**	$338,820.00	$313,640.00	$326,480.00
Plus Tax On Retained Earnings of $100,000	$ 46,500.00	$ 46,500.00	$ 46,500.00
Total Tax If Complete Distribution And Retention of $100,000 By Corporation of Earnings	$385,320.00	$360,140.00	$372,980.00
Tax Savings To Stockholder If $100,000 Salary Paid and Earnings of $400,000 Retained by Corporation.	$ 96,957.50	$86,457.50.50	$ 91,457.50

*$110,500 derived from deducting tax of $189,500 and first $100,000 of earnings exempt from penalty tax.
**$50 exemption and 4% Dividends-received credit not taken into account in these figures.

Other tax factors distinquishing the two forms of doing business are as follows:

A corporation must pay unemployment taxes on salaries paid to the shareholder-employees. Such payments are usually withheld from the employee's wages and may be classified as a deductible business expense or tax expense.[117] Partners are subject to a self-employment tax if certain provisions are satisfied according to the Federal Tax Law.[118]

Stockholder-employees may participate in one of several tax exempt pension plans which have four excellent tax advantages as follows:[119]

1. The corporation obtains a deduction currently for the full amount contributed to the qualified plan, trust or insured;

2. The plan which is usually in the form of a trust can accumulate money tax-free until actual distribution is made to the employee and the investment income of the trust is tax-exempt;

3. The employee is not taxed while the funds are being accumulated in his behalf until, and only until, he receives his portion of the money;

4. A possibility of a long-term capital gains tax assessed to the employee upon his withdrawal of his portion from the pension fund.

This device allows a stockholder-employee to create a substantial retirement income for himself with

tax-free dollars, and, at the same time, obtain a split-income advantage by delaying tax payments on the sum contributed to the pension fund until later in his life when his income tax bracket is lower. A close corporation with one or more stockholder-employees may qualify for the special benefits of pensions, profit sharing* or stock bonus plans. The latter two plans also qualify for preferable tax treatment similarly as above described for the pension. The partnership does not have these benefits available to the working partners.

Long-term capital gains are first taxed to the corporation and, when disbursed as dividends, are again taxed to the stockholder. The partner pays the same tax but only once.[120] (The maximum effective rate on long-term capital gains for both corporations and individuals is 25%; however, a corporation cannot pay less than 25% but the individual partner may pay as little as 10%).

Capital losses of a corporation cannot be used to offset any capital gains which the stockholder may have, nor can they be used to offset other income of the corporation.[121] Capital losses of a partnership become the capital losses of the partner and may be used by the partner to

*This plan is based on a percentage of the gross profits before taxes or a percentage of the company's payroll whichever is the lesser amount. This is an advantage over the pension plan since under the latter, contribution is made regardless of the company's profits.

offset any personal capital gains.[122] The partner can use the capital losses to the extent of $1,000 a year to offset other income.[123]

If the corporation is paid dividends, only 15% of the total received is subject to tax.[124] This means that the corporation pay an effective tax of 4-5% on received dividends if its total income does not exceed $25,000, or 7-8% if its income exceeds $25,000. The partner receives the previously mentioned $50 exclusion and 4% dividends-received credit. The corporation, therefore, may be utilized as a holding company and obtain this tax-saving on the condition that it can retain the income and, eventually, pay it out as a long-term capital gain or as salary to the stockholder-employees.*

Under the corporate form, the stockholder-employees may have their entire medical expenses paid for by the corporation. These payments may be deducted by the corporation although the benefits are extended only to a limited number of individuals or to a single individual. The recipients acquire the payments under this plan tax-exempt. The employee may also deduct up to $100 a week from his income received under a wage continuation plan for absence from work due to personal injuries or sickness.**[125] The partnership, in contrast,

*The collapsible corporation may come into effect here.
**After a waiting period of seven days unless hospitalized one of these days.

does not offer these benefits to the partner under existing tax laws.

All of the above listed comparative beneficial incidents as they may each respectively apply to either the partnership or corporation are equally applicable to the pseudo-corporation. Thus, this hybrid form of business organization retains the taxable advantages present in both basic tax forms it draws upon for its own existence.

Election of Corporation To Be Taxed As A Partnership - Pseudo-Corporation

The corporate owners may now elect to be taxed as a partnership and still retain all other legal and financial incidents of a corporation.

In order to qualify for this election, the corporation's structure must have the following characteristics:[126]

(a) It must be a domestic corporation where

(b) all stockholders are individuals or estates. There may not be a trust, corporation or partnership as a stockholder.

(c) No stockholder is a non resident alien and there must be

(d) only one class of stock which is outstanding.

(e) The corporation is not a member of an affiliated group of corporations tied to a common parent.

(f) All stockholders agree to the election to

treat the corporation as a pseudo-corporation.

By electing to be taxed as a partnership, the corporation's earnings are taxed directly to the stockholders in proportion to their interest in the company as though they had received dividends at the end of the corporation's taxable year.[127] The stockholder must report the income from the electing corporation as ordinary income without benefit of the exclusions or dividend received credit allowed on corporate dividends. The shareholders must include in their own income for tax purposes the current taxable income of the corporation, both the portion which is distributed and that which is not.

This new elective right under the tax laws has opened the door to many businesses which wish to operate under the corporate form but were hesitant to do so because of the double tax on the income of the business. Now an unincorporated form of organization may incorporate and receive the tax benefits of the partnership structure and, for all other intents and purposes, operate the company legally, financially, and structurally as a corporation. In addition, the election to be treated as a non-corporate taxpayer does not disqualify the corporation for such incidental tax benefits as profit sharing, pension, and life insurance plans.[128]

In the purchasing or selling of stock of a pseudo-corporation, the following points should be considered:

1. A sale of even one share to a person who makes the eleventh stockholder, or to a corporation, trust, or partnership automatically ends the election and the corporation is again taxed as an association retroactively to the beginning of the year of said transfer.[129] This may have important tax consequences for all shareholders.

2. If stock is sold to a person who doesn't consent to the election, the election automatically ends beginning with the year of the sale.[130] Thus, if the existing shareholders wish to maintain the election, it is important to be sure that any new stockholder will consent to the status quo.

3. In the event that a stockholder purchases a share of stock in the middle of a year when the election is in effect, he will have to pay a personal tax on his share of corporate income earned in the part of the year before he became a stockholder.[131] Therefore, some adjustment must be made for this liability in the purchase and sale price of the stock. It may be possible, if state law permits, to restrict new shareholders from withdrawing their consent of the election by an endorsement

on the back of the stock certificate similar to the prevalent restriction in the transferability of the certificate before discussed. Nevertheless, if such restriction is not permitted, the usual restriction of transfer as shown on the attached certificate will preclude the sale of the shares unless they are first offered to the company and arbitration is completed.

Thus, we find that the election may be terminated involuntarily if there is a lack of unanimity of all stockholders regardless whether it is accidental such as when a stockholder or his heirs violate one of the precedent conditions essential to maintain the pseudo-corporate status. Such a violation will operate to retroactively affect the tax structure of the company to the beginning of the year whether fiscal or calender.

Pseudo-corporate treatment will be most advantageous when the corporation must distribute substantially all its earnings, whether due to the needs of the shareholders or due to the threatened imposition of the accumulated earnings tax . Of course, reasonable shareholder-employee salaries are already a deductible expense of the corporation taxed as an association and, therefore, are not subject to the double tax when a comparison is made with the pseudo-corporation. However, the shareholders' tax brackets are important where the Commissioner of In-

ternal Revenue may reallocate distributions of salaries in family corporations to reflect true value of services rendered by the participants. The pseudo-corporation alleviates this potential difficulty. The important advantages of exercising the election to be a pseudo-corporation are the avoidance of the double tax, the treatment of capital gains, and the allowance of the corporation's net operating loss as belonging to the shareholders. These may be insignificant advantages to an existing corporation which does not anticipate losses or capital gains and in which double taxation is not a hindrance, either because what otherwise might be dividends is withdrawn as salaries or because shareholders wish to retain the earnings in the corporation because of their already high income tax brackets. Under certain circumstances, therefore, it may be more advantageous to let the corporation to taxed as an association. Although the partnership may now incorporate and still retain its tax structure through the election of being taxed as a pseudo-corporation, this by itself may have a negligible effect, but when the partners understand the fringe benefits only possible under the corporate form such as deferred compensation plans and pension plans, the usefulness of this device is more apparent.

The additional advantage of the election is the

fact that the capital gains acquired by the corporation may be directly passed through to the shareholders who, in turn, would have the benefit of the low 25% tax.* This is a very useful method of withdrawing one's capital from the business without being penalized too severely tax-wise. In addition, the net operating loss of the corporation may be directly deducted by the shareholders allowing them the advantage of offsetting income from other investments. The right to use a pseudo-corporation adds an incentive to buying a stock of a corporation with high basis assets which have relatively low value. The sale of the assets by the corporation can result in an ordinary loss deduction for the new stockholder through electing to be taxed as a pseudo-corporation.[132] Example of this is the following:

> The X Corporation has a basis of $200,000 for fixtures, equipment, and building worth $100,000. Assuming that all other assets are offset by an equal amount of debts, Mr. A buys all the stock from X Corporation for $100,000. He elects to have the corporation taxed as a pseudo-corporation, sells its fixed assets for the $100,000 and buys new modern equipment. He can deduct the corporation's $100,000 loss on the sale of the fixtures as an operating loss on his own return even though he has no economic loss. The caution to be used here is that Mr. A may have to prove that he did not buy the corporation for the sole purpose of the tax loss derived therefrom; otherwise the loss may not be permitted by the Treasury.

Another important advantage may be the accessibility

*Long-term capital gain is taxed at 25%; short-term capital gain is taxed at 50%.

of debt financing to the corporation. Ordinarily, the treasury's claims for income taxes against a corporation come ahead of most creditors.[133] Thus, in giving credit or making loans to a corporation, the creditor must be on the lookout for undisclosed tax liabilities. Unexpected tax claims against the corporation may make the claims of business creditors completely worthless. However, a corporation which elects to be taxed as a pseudo-corporation has a completely different credit position. It has no income tax liability because the tax on its income is a liability of the stockholders and not of the company. This aspect granting the corporation no liability for taxes will also make a better balance sheet and profit and loss statement from an accounting viewpoint.

The procedure suggested in the determination of a form of business tax-wise must necessarily be between the two basic differences of the partnership tax and the corporate (association) tax. Once the method of taxation is decided as the best for the individual purposes of the investor, he must then choose according to the other factors which have a bearing between the proprietorship, partnership, and limited partnership on one side of the coin or the joint-stock company, business trust, and corporation on the other side of the coin. The hybrid form herein called the pseudo-corporation must then be

compared with the choice form. If the corporation is the "best" form without considering the tax consequences, then a comparison of the tax incidents of the corporation and the pseudo-corporation must be considered to best decide which of the two entites would best fit the circumstances of the owners and their business. It must be remembered that once the election is made to be taxed as a pseudo-corporation, it may be revoked at any time thereafter at the will of the stockholders.[134] However, once the election is revoked, neither the corporation nor any successor corporation can make a new election for any year before the fifth year beginning after the first year for which the termination or revocation is effective.[135]

Of necessity, any computation of future taxes must be made on the basis of assumptions. The most important of these include the following:

1. As to the projected business one must consider its gross income, the amount and character of the taxes, the operating expenses including salaries, commissions, etc. to be paid to the owners of the business if it is incorporated, and also, in such case, the amount of dividends which will be paid.

2. As to the individual owners, one must consider their family status, their other income, and their philanthropic propensities (charitable contribu-

tions are tax deductions in the case of individuals generally up to 20% of their adjusted gross income and in the case of corporations up to 5% of the net income.)

ESTATE PLANNING - ANTICIPATING DEATH

If we assume that a businessman enters business to derive the benefits of income and profit and that this allows him to satisfy his personal and family needs before and after his death, then the planning required to preserve his wealth, estate planning, plays an important role in his business choice.

The anticipation of death or complete disability from continuing the business enterprise requires planning for substitute management, continuity of life of the business, and the method of disposing of the interests in the company. This phase of the businessman's planning and its effect on the choice of the business form of organization plays more heavily than what may appear at first sight. The tax element also affects the provisions for conveying the investor's proprietory interest whether during his life or after his death. We shall therefore analyze generally the estate, gift, and inheritance tax aspects of the estate plan of the entrepreneur.

Among the basic facts to be ascertained before an estate plan may be formulated are the following:

1. The extent and nature of the individual's wealth including all his personal assets, tangible and intangible, and the obligations outstanding, real and personal, as well as the prospective liabilities that may arise at the date of death (the date of death may occur

at any time and this indefiniteness causes difficulty in determining the man's wealth but this may be partially overcome by projecting his position one year from date, three years from date, etc.). Some obligations which arise after death are the expenditures for estate and inheritance taxes, administration expenses, and the payment of after-death debts whether incurred before or after the decease. In addition, the problem of distribution of the deceased's assets and the availability of sufficient cash for payment of all the main and incidental expenses must be provided for by the entrepreneur.

2. Who are the investor's business associates; who are his expected heirs and successors; who are his natural devisees and legatees? Among these classes of persons, what are their present status and their potential positions in the business, measured in terms of ability, inclination, and financial resources? This is a determination of whether the owner has the desire to preserve the business as a going entity after his death by retaining his interest for the benefit of his estate or heirs. Under the present estate and gift tax laws of the Federal Government are the essential following provisions to be cognizant of when developing an estate plan:

a. The first $60,000 of the estate is exempt from federal estate taxation.[136]

b. The valuation of the estate's assets may be,

at the option of the executor, as of the date of death or one year thereafter except as to transfers made during the first year after death which must be valued as of date of transfer.[137]

c. Estate Tax Return must be filed and payment made within fifteen months after date of death.[138] A preliminary information return must be filed within sixty days after death or within sixty days after qualification of the executor or administrator.[139]

d. The present estate tax rates are no less than 3% and progress as high as 77%.

e. A credit for payment of inheritance taxes to the state is allowed in the computation of the estate taxes paid the Federal Government.[140]

f. Married persons may utilize the marital deduction which allows the surviving spouse one-half of the estate's value tax free as long as the marital deduction is properly developed in the decedent's will and the receiving spouse survives the deceased.*[141] The proper use of a marital deduction exempts a gross estate worth $120,000 or less from estate federal taxes.**

g. The requirement with respect to the filing of tax returns is determined by the value of the gross

*This applies to either husband or wife.
**See Appendix for chart displaying tax effect with and without marital deduction.

estate and not by the net taxable estate after all allowable deductions and exemptions.[142] The gross estate of a decedent is the total value of all property whether real or personal, tangible or intangible, and the decedent had beneficial ownership at the time of his death.

h. A single taxpayer has a lifetime gift-tax exemption of $30,000 plus $3,000 annually to each recipient if it is a gift of a "present interest". A husband and wife jointly have a cumulative exemption of $60,000 and $6,000 annual exclusion per donee if consent is given by both.[143] In order for the gift to qualify as a "present" interest, it must give the donee an unqualified right to use, possess or enjoy the property.[144]

i. Where the decedent's interest in a closely held business exceeds 35% of his gross estate or 50% of his taxable estate, the estate tax may be paid over a period of ten years with interest at 4% per annum.[145]

In order to allow the business sufficient cash on hand to purchase the withdrawing investor's interest whether from death or retirement, it may be advisable to draw up a "business continuation agreement", more often referred to as "Buy-Sell Agreements". This form of agreement allows the business to purchase the retiring partner's or owner's share without leaving the business in an hazardous condition from lack of sufficient working capital.

The agreement may also involve the prudent use of life insurance.[146] The objectives sought usually include the following:

1. The business is to continue after the death of one of the owners for the benefit of his associates; and

2. to assure a market and fair payment to the decedent's estate for his interest in the business for the benefit of his heirs.

Sole Proprietorship

The sole proprietorship is the one business form most completely dependent on the life of the owner. The one compensating feature of being with an independent life is the fact that the estate plan may be developed solely on the criterion of what is best for the owner and his beneficiaries without the need to compromise with the conflicting interest and desires of partners or fellow stockholders.

If the owner is the sole manager of the business and there are neither heirs nor employees to continue the business operations after his death, then the objective will be to liquidate the business.* The proprietor may dispose of the business by a sale of the enterprise as a going concern or by a piece-meal disposal of the assets with a probable substantial loss of good-will ("good-will does not adhere to a business or profession dependent

*In this event, the sale may be subject to the Bulk Sales Act.

solely on the personal ability, skill, integrity, or other personal characteristics of the owner.")[147]

In the anticipation of disposing of one's proprietory interest in the sole proprietorship, the owner must recognize the fact that any agents or attorneys-in-fact appointed by him during his lifetime are automatically deprived of their authority after the owner's death because of the rule of law that such agencies lapse with the deceased of the principal.[148] This rule of agency further suggests that an inter-vivos trust should be created during the owner's life to carry on the business interests. The trust would take the business assets out of the estate and thereby most likely save the estate and heirs substantial taxes and, at the same time, give the testator an opportunity during his life to make sure the business will be properly managed after his death.[149] The exception of this method of succession is the law that any transfer made within three years of the testator's death shall be considered in "contemplation of death" and, if so decided by the Treasury, the business assets will be includible in the estate for tax purposes but it will not terminate the trust's effectiveness in the management and control.[150] This method of disposing of the proprietorship may be completely supervised by the owner during his life and he may reserve the power to terminate the trust by making the trust revocable in contrast to the irrevocable trust. Another method which may be employed is to

give the owner's personal representative expressed testamentary powers to liquidate the business if it be for the best interests of the estate.[151] Such expressed testamentary powers should include the following:

1. To liquidate the business during a period of time as the executor in his discretion may deem advisable in the event the period required extends beyond the time to administer the estate. This power to continue the enterprise during the executor's management of the estate requires the further authority to continue the business during the period of delayed liquidation.

2. To employ attorneys, accountants, agents, and employees in the temporary conduct of the business with reasonable compensation.

3. To borrow money if required as in his judgement he may deem necessary to continue the business until liquidation is effective with full power to secure repayment thereof by any necessary legal instruments.

4. To sell in whatever manner seems advisable the various assets of the business either separately or together for cash or its equivalent and to execute all the necessary legal papers as deeds, bills of sale, assignments and mortgages; all without application to or order of the probate court. (This is one of the disadvantages of testamentary dispostion of a business since the probate court in its discretion may impose restrictions on the powers

as granted the executor under the testator's will. All accounts of proceeds and expenses must be submitted to the court for its inspection and allowance.)

Because these testamentary powers presuppose a very high degree of trust and confidence in the primary executor, it is wise to provide for successor executors in the event that the first named executor is unable to act in behalf of the estate.

In the event that an employee is the successor of the business, provisions may be made during the owner's life to allow for payment of the business analogous to methods employed in partnerships, or the business may be left outright to the employee as a legacy. Other provisions may provide that the employee is to pay a sum certain over a period of time to the estate or the decedent's heirs.

The basic legal principle to be remembered by the testator is that an executor has not the power to continue a going business beyond the absolute requirements of liquidation unless otherwise provided by will.[152] Therefore, the inter-vivos trust seems the most advisable method of disposition. The additional problem of violating the Rule Against Perpetuities and the rule against the accumulation of income in the use of the trust or the testamentary powers of the will are other technicalities to be aware of in the drafting of these provisions.[153]

In an attempt to avoid the apparent complications

of the above methods of disposition, the "estate corporation" has been increasingly utilized. Estate corporations may be defined as (1) any close corporation where the personal representative of the deceased has a controlling interest or (2) any corporation organized by executors or trustees pursuant to testamentary powers in order to retain and control a decedent's business or his investment holdings.[154] In the absence of expressed authority, the executor or trustee is not permitted to incorporate the decedent's business.

The apparent difficulties and involved technicalities encountered in the succession of the proprietor's business give persuasion to the practical desire of the owner to modify his business form into one of the other types of organization if his prime objective is to leave the business as a whole to his heirs. In addition, the sole proprietorship does not allow its owner to gift part of his business interests during his lifetime to his beloved ones in order to diminish his estate valuation resulting in savings for administration and estate tax consequences. He is unable to utilize to the fullest his gift tax exemption during his life by transferring tax free the greatest proportion of his wealth in this form of business organization. This factor in conjunction with the difficulties often encountered in the estates of large size gives impetus to the many advantages found

in the other forms for estate and gift tax incidents. The problem of testamentary disposition is not prevalent in the ordinary businessman's mind. This is to be expected since one does not necessarily think of death when he commences a new enterprise; nevertheless, the problem of disposition must eventually catch-up to the owner and influence his business form. Again, the choice of the "best" form of business organization must rest upon all the factors previously discussed and the decision of the form may, for a temporary period of time, be the so-called "best" for the circumstances then prevailing but, as circumstances change, a review of the business organization is needed and accordingly modified to better fit the existing conditions.

Partnership Agreement Provisions In Contemplation of Death

In the absence of an agrement to the contrary, the rule of partnership is that upon the death or withdrawal of one partner, the partnership must wind-up its affairs. The surviving partners are prohibited not only in continuing the business but also in the use of the partnership's name, the style under which the business has operated.[155] Nevertheless, it is possible to provide for the continuation of the business by contract between the partners, such as a provision to the effect that the partnership is owned as joint tenants and not as a tenancy in partnership so that the surviving partners automatically

become owners of the business property by operation of law upon the death of a co-partner.[156] A more frequent arrangement is to grant the surviving partners an option to continue the business by purchase of the deceased partner's share or to liquidate the business allowing distribution of a proportionate share of the net worth to the decedent's estate.[157] Another available method is to allow the survivors to continue the business and pay the estate or a named beneficiary a predetermined fixed sum either as a single payment or over a period of time.[158] The primary question is the treatment of the income tax burden on such post-death payments. If the payment in the purchase of the decedent's share of the business is the price for the acquisition of the deceased's share in the firm, the entire amount is taxed to the surviving partners without a deduction for the payments to the estate of the deceased.[159] When the payments are considered distributions of income to the estate as if the latter was a member of the partnership, such payments are taxed as income to the estate and not to the surviving partners.[160] The conclusion in each case is dependent upon the construction given to the particular partnership agreement.

It is possible for the business to continue after the partner's death placing the personal representative into the shoes of the deceased partner. This form of

of agreement need not comply with the Laws of Wills since it is not considered testamentary in nature. However, the agreement will be strictly construed and its legal effect, although allowing the old partnership to continue, is to create a new partnership between the surviving partners and the present representative of the decedent.[161] If the terms of the partnership agreement, which should be confirmed in the decedent's will, are not self-executing but instead allow an option to the estate to elect to continue the business in conjunction with the surviving partners, it is wise to leave the exercise of such an option to the discretion of the executor.[162] Of course, the partner is free to dispose of his partnership interest by a legacy under his last will and testament but, unless the surviving partners create a new contract of partnership with the legatee, then he is not a partner ipso facto.

Many of the problems faced by the sole proprietor and the partner in their dispositions of the business are derived from the characteristic of these business forms that the business is not a self-perpetuating type of legal living entity as the corporation and other forms under discussion. The doctrine of delectus personae in the partnership and the difficulty of continuing the business of a sole proprietorship without the sole owner present are the basic pitfalls that must be overcome in order for

the deceased owners to leave their beloved ones protected and provided for in the business. The partnership form, as in the sole proprietorship, does not allow the investor the available advantage of disposing of his interests during his life through the use of tax free gifts under his cumulative and annual exemptions. The technical involvements are made apparent by this discussion and, many times, the well planned will has been the subject of costly litigation. The will is an untested legal document with the attendant supervision of the probate court as an overseer. In contrast, the corporation and the other forms have "perpetual" life aside from the investor and continue their operations and retain their structure after the absence of the owner. The latter forms have been tested and supported over the years in their operations offering stability and security in their functions. The disposition of one's interest in such forms does not open the door for litigation and court supervision as present in the sole proprietorship and partnership.

Stock Holdings in The Close Corporation, Business Trust, And Joint-Stock Company

The following discussion of the corporation pertains equally to the business trust and the joint-stock company since all these forms have a separate continuous life independent from the investor and each have transferable ownership certificates.

The testamentary disposition of the owner's stock in the corporation presents the least amount of legal difficulties and practical problems because of the fact that this form of organization has a separate and distinct life than that of the deceased owner. Whatever difficulties encountered are usually traceable to the fact that the corporate enabling statutes do not distinquish between the close corporation and the large publicly owned corporation. The large public corporation usually has a continuous open market for its issued securities which may be readily converted into cash; its valuation of securities may be easily ascertained. The close corporation does not have such a market in its securities and, therefore, it is necessary to find methods of evaluating the stock certificates, that is, the decedent's proportionate interest in the enterprise for estate tax purposes. In addition, the retention of control is not as vital to the holder of securities in a public corporation as it is in a close corporation.

The following points should be considered in the disposition of the deceased's securities:[163]

1. The will should grant powers to honor and perform any shareholders' agreements to which the decedent was a party and are still in effect at the time of death;

2. Subject to such agreements, the executor or

trustee should be expressly empowered to retain the stock at his discretion, notwithstanding that the investment may not be legally sanctioned for trustees and regardless whether it becomes non-income producing during its retention.*

The variety of instruments that may be used for equity financing in the corporate form can greatly facilitate the disposition of the decedent's interest before and after his death. The different types of stocks may be given by will or inter vivos gift and each may serve the specific purpose intended by the testator. For instance, the common (voting) stock may be given to those persons who will best fulfill the management of the business; the preferred stock and bonds to those who are not to be active in the management of the corporation but are to receive the senior and presumably safer stock for fixed income. The senior stock may also be used as collateral for the obtaining of loanable funds and are usually more marketable because of their safer position in the business. The senior securities may also be the feasible method of granting charitable gifts without invading the control and management of the business. In the event that the testator has mental reservations in his choice of the management and control recipients of the common stock, he may allow the

*Many states impose legal restrictions relative to permissible investments by trustees and other fiduciaries unless the testator grants freedom of action in such investments.

preferred stock to have the right of convertibility into common stock and thereby allow such holders of the senior stock to have participation in the control and future growth of the company. In addition, when only profit participation is desired, the testator may make the preferred stock participating shares entitled to an additional part of the profits either over and above the stipulated return or as the only return from the ownership of the stock. This method of dividing the ownership interests in the corporation further grants the owner the ability to gift most of his proprietory interest during his life without conflicting with his desire to retain control and management of the corporation. The gifting of a high valued preferred stock or bond during his life will lower the estate value which, in turn, will eliminate much of the taxable estate and, at the same time, allows the testator complete control of the business providing for the succession of the corporation's management and control by testamentary provisions in his will. This is one of the tax saving devices that may be used which is not present in the sole proprietorship or partnership.

It is often desirable to provide for post-death payments by the corporation to the widow and other dependents of the deceased officer of the business. Such payments are deductible expenses, even if given by the business voluntarily, to the corporation provided they are reasonable

in amount (maximum seems to be the employee's compensation during his active role in the business) and for a limited period of time. If the payment is made to the estate of the deceased officer instead of to his personal beneficiaries, it shall be considered income to the estate.[164] If the payments exceed $5,000 to the personal beneficiary and are pursuant to a contractual relationship, then the amount is considered taxable income to the recipient.[165] A redemption of stock to pay estate, inheritance taxes and funeral, administration expenses is not treated as a dividend distribution where the value of the decedent's stock in the corporation is either more than 35% of the value of the gross estate or more than 50% of the taxable estate provided the termination of the decedent's interest in the corporation meets certain tests as set forth in the tax laws.[166]

The use of life insurance as a method of securing sufficient funds for the payment of the deceased's share of the business is very popular and a device widely used today.

Upon the death of the stockholder, the cost basis of the shares to the recipient becomes the fair market value at the time of his death or one year later at the option of the personal representative. However, in the event that the stock is gifted during the stockholder's life, the

donee's cost basis is the same as that of the donor. This may mean a larger capital gains tax when the donee sells the shares but the tax incurred at the rate of 25% maximum on long term capital gains may be much less than the estate tax imposed if the shares are included in the taxable estate of the deceased stockholder.

SUMMARY AND CONCLUSIONS

Challenge of Choice

Because the business climate of our contemporary society is continuously striving towards higher levels of progress, the basic determinants of choice may be today the unimportant and inapplicable incidents of tomorrow. The determination of a business form of organization must call upon elements which are involved with the social science of inter-relations between people and juristic entities. The need of today's businessmen is to be conditioned to think of their position in the framework of a progressive economy. The approach in the determination of the "best" business form must consider the functional aspects and their application to the important daily and future needs of the investor and his role in society. The businessman has an obligation to himself primarily and then to those he services in the community. His activities naturally flow from his desires to achieve the standard of success as developed in his environment and his mind. The procedure employed to obtain his personal desires will have a substantial effect in his accomplishments. It is important, therefore, that he have a criterion of investigation and insight into his present and expected position which requires an analysis of the basic and vital determinants

of his choice of business form.

It should now be apparent that the factors herein discussed are basic determinants in the choice of a business form of organization. These factors are variables and their degree of importance to the entrepreneur depends upon his personal status of wealth and opinions in the operations of an enterprise. Because each set of circumstances are not always exactly similar, the application of each described factor will accordingly affect the ultimate decision with greater or lesser importance. Until a utopian form of business organization is developed which will have universal treatment by the businessman as well as the social institutions such as the courts and governments, the interplay of the several determinants upon the different business structures will, in the meantime and, unfortunately, for some time to come, continue to offer the businessman the challenge of choice.

Principles of Action

The basic factors affecting choice have been analyzed and it is now possible to summarize the several advantages and disadvantages of the business forms of organization.

Sole Proprietorship

The following are the chief advantages of the proprietorship:

1. Ease of formation with few if any formalities.

2. Flexibility of management and movement.

3. Incentive to produce and supervise because of personal liability of owner.

4. Independence and personalized control.

5. Lack of formation expense and upkeep of form.

6. Freedom from governmental control in doing business.

7. Simplified taxation on business income.

8. Liberty to dispose of business without consultation with others during and after life.

The following are the disadvantages of the proprietorship:

1. Lack of obtaining large sums of capital with limitation of debt capital only.

2. Personal liability for all debts of business.

3. Lack of independent life of business causing instability.

4. Dependence on agents and employees for the delegation of authority which limits expansion.

5. Unavailability of tax benefits otherwise granted to the forms taxed as associations.

6. Problem of succession of business during life or by will.

General Partnership

The following are the advantages of the general partnership:

1. Simple and inexpensive organization.

2. Personal incentive present from unlimited liability and proportionate sharing of total profits.

3. Retention of control from presence of delectus personae.

4. Governmental control relatively absent.

5. Inexpensive to maintain its structure.

6. Well defined principles of law to guide the firm's actions internally and externally.

7. Simple tax assessments federally and locally.

The following are the disadvantages:

1. Lack of stability due to limited life and freedom of action by co-partners.

2. Must consult with co-partners for authority to perform major acts.

3. Unlimited personal liability for firm's debts.

4. Limited to debt financing usually.

5. Vulnerable to internal dissension.

6. Lack of independent life with possibility of dissolution imminent.

7. Problem of providing for succession in business.

Limited Partnership

The advantages of the limited partnership are

similar as that listed for the general partnership except for the following:

1. Limited liability for limited partners.

2. Proportionate profit sharing with limited investment.

3. Assignment of limited partner's interest without consent of co-partners.

4. Availability of equity capital without the onerous aspects of becoming a general partner.

The following are the additional disadvantages not listed in the general partnership above described:

1. Technical formalities to be carefully followed.

2. Complete lack of control or supervision of management.

3. Not recognized in other states unless first qualify to do business.

Joint-Stock Company

The following are the advantages of the joint-stock company:

1. Inexpensive and simple to organize.

2. Accessibility of equity and debt financing.

3. Transferable ownership interests.

4. Possibility of maintaining limited liability.

5. Centralization of management avoids dissension.

6. Flexibility of expansion, management, and movement.

7. Comparative lack of government controls.

8. Replacement of management by owners.

9. Independent and continuous life.

10. Facility of disposing of one's interest by gift or will.

11. Availability of tax benefits offered by being taxed as an association.

The following are the disadvantages present in the joint-stock company:

1. Unlimited liability ofttimes unavoidable.

2. Lack of knowledge of its operations distracts possible investors.

3. Double taxation present on payment of dividends.

4. Lack of the personal element present in sole proprietorship and partnership.

Business Trust

The following are the advantages of the business trust:

1. Its formation is comparatively simple and inexpensive.

2. Allows the aggregation of capital.

3. Limited liability of the beneficiaries if trustees are independent of their control.

4. Gives stability in management and control.

5. Comparative freedom from government control.

6. Federally taxed as an association with the availability of the tax benefits thereby granted.

7. Preferential tax treatment in some states.

8. Transferable ownership interests.

9. Facilitates the disposition of one's ownership interests during life by gift or after death by will.

10. It has an extended life granting it permanence and stability.

The following are the disadvantages of the business trust:

1. Beneficiaries have no control over management if limited liability is to be maintained.

2. Personal liability present unless complete independence of trustees.

3. Not recognized as a legal or workable form by many jurisdictions.

4. It is limited in duration.

5. Cannot substitute trustees unless for cause or vacancy.

6. Lack of knowledge of operation and structure by investors limits availability of capital.

7. Double taxation on distributions federally.

8. Lack of uniform treatment by the several jurisdictions limits flexibility of expansion and movement.

9. Lack of flexibility in management.

Corporation

The following are the advantages of the corporation:

1. Possibility of aggregating large sums of capital.

2. Operations and structure well known by investors and popularly accepted by the business community.

3. Limited liability of stockholders.

4. Uniformily treated by all jurisdictions.

5. Continuous independent life.

6. Accessible market for securities.

7. Adaptable to efficient management.

8. Flexibility of expansion and movement.

9. Tax benefits federally by splitting of income and fringe benefits.

10. Ownership interests easily gifted or disposed of by will.

The following are the disadvantages of the corporation:

1. Expensive and technical formation.

2. Expensive and technical requirements to continue upkeep of existence.

3. Management and stockholders usually separate individuals.

4. Strict governmental control and requirements.

5. Double taxation on income.

6. Must qualify before operations in other states.

7. Must file documents revealing certain information open to public inspection.

8. Limited liability is frequently inapplicable in the obtaining of debt financing from banks.

9. Many tax requirements and penalties demand a continuous close study.

10. Must frequently call upon professional help to maintain the company's existence.

Pseudo-Corporation

The pseudo-corporation has all the advantages of the corporation but none of its tax disadvantages. After a study of the several business forms of organization with their respective advantages and disadvantages, it is apparent that the choice of the entrepreneur under the usual circumstances and as a practical problem is basically between the proprietorship, partnership, or corporation. The business trust, limited partnership, and joint-stock company may each be the chosen form under certain conditions but, as a general proposition, these business forms rarely come into contention as do the former three. The recent inception of the pseudo-corporation will probably be well received by the investor because of the advantages it offers structurally, financially, and tax-wise. When an investor is dealing with a reasonably large amount of capital, say no less than

$5,000 as an arbitrary figure, and he is not in a personal service business with few physical assets, the pseudo-corporation would probably be the choice form. The pseudo-corporation grants him the tax benefits of both the sole proprietorship and the corporation and as well offers the advantages of limited liability. This form also adds the flexibility to expand geographically with an existing management structure usually required for the handling of a more complex business. It further allows the owner to obtain the necessary additional working capital through the use of the varied equity instruments present in the corporate form. In addition, as the investor's earnings increase, he may at will revoke the election of being taxed as a pseudo-corporation in order to obtain the advantages of splitting his income with the resulting tax savings. In other words, it is here suggested that the entrepreneur should, at the inception of his business venture, adopt the corporate form of business organization instead of the proprietorship if his capital investment exceeds a certain lump sum and, more especially, if only a part of his wealth is invested and his prime concern is limited liability. This will afford him the means of expanding his operations without delay and costly modifications at a later date with a workable and permanent structure. The corporate form provides the essential structure to adapt the business operations more economically for

expansion. Prior to the creation of the pseudo-corporation, there was good cause not to form a corporation prematurely because of the tax consequences. Now that this barrier is eliminated, the forward-looking ambitious investor may obtain more tax benefits and the legal protection and financial flexibility of the corporation by electing to be taxed as a pseudo-corporation.

In conclusion, the writer believes that under the existing tax laws, legal and financial incidents, and the available flexibility provided for a mature estate plan, the corporate form of business organization offers the investor, in the long run, most of the essential characteristics usually desired for a fulfillment of his existing and future needs. The sole proprietorship is most appropriate for a single investor requiring little capital to commence his business venture and who intends to limit his operations to a one man business. The general or limited partnership is most appropriate for a group of men who, either by law or tradition, are unable to incorporate but wish to join their talents or resources together for the benefit of all. The business trust is most appropriate for a group of men who wish to join their capital together in a limited venture with total agreement that one or two of the group shall have complete control of the business. An example of a business trust is the purchase of a large office or apartment building whereby the managment is in one or a few of the investors because

of their knowledge or of the fact that the investors have other business interests to occupy their full time. The joint-stock company is most appropriate for several businesses to join together for a mutual interest, such as the purchasing of materials, with the necessity of having respective representation in the organization with the idea that the mutual purpose is limited to that one function. Each of the several forms have certain benefits that may more than outweigh the detriments under particular circumstances. A business may have one function which may best operate under the partnership form and another function which may best operate under the corporate form. For instance, the flexibility of the partnership to do business in the several states is superior to the corporation in this one respect; therefore, it is not infrequent that a corporation has formed a partnership to handle the sales offices located in many jurisdictions and retain its own form for the production of its goods.

A proper study of the following factors will aid the investor to chose that form which will "best" fit his needs in business:

Facility of Formation: The simplier forms offer greater ease of movement and flexibility such as the sole proprietorship, general and limited partnerships.

Feasibility of Aggregating Capital: Unless the investor

is able to provide the essential capital for present and projected needs of the business, the more complicated forms of organization with a centralized management, the business trust, joint-stock company, and corporation, should be adopted to attract equity capital through the available variety of financial instruments.

Subjection to Risk: If the entrepreneur has substantial wealth not devoted to the investment, the additional costs and inconveniences present in the reliable forms offering limited liability should be considered and adopted such as the limited partnership, business trust if accepted in the jurisdiction, and corporation.

Flexibility of Expansion, Management, and Movement:

The required flexibility depends on the geographic area of the business's operations and markets, the type of business, and the type and kind of restrictions imposed on the business by the government or courts of the states in which the company operates. It may be advisable to utilize a combination of the several forms to facilitate the movement and expansion of the business.

Longevity of Organization: The forms offering "continuous life" grant security and stability to the investor which is most often considered upon the contemplation of death by the owners. Frequently, the entrepreneur will eventually adopt the form offering this feature and,

therefore, the use of the form possessing this feature from the inception of the investment must depend largely on the other factors.

Legal Status: It is wise to select that form which has definite guides of legal incidents in the jurisdiction governing the business contemplated.

Government Omnipotence: The variety of restrictions imposed on each form may offer undue interference and inconvenience to the entrepreneur. The choice must be made in relation to the frequent irksome details required by the particular governments.

Taxation: The expected profits and available funds have a substantial bearing on the investor's choice of business form. There is a substantial difference of federal income taxes between the proprietorship, partnership, and limited partnership on one side and the business trust, joint-stock company, and corporation on the other. The pseudo-corporation should be closely studied in this single factor.

Estate Planning: A complete survey of the individual's wealth and its disposition should be considered before the choice is finally determined. The tax effects on estate values and the available methods to avoid their consequences by gifts to children (family partnerships, use of Uniform Gifts to Minors Act, stock gifts) should be seriously considered before the investor's election.

APPENDIX

A.: Definition of Personal Holding Company

The personal holding company is a corporation where more than 50% of the stock is owned directly or indirectly by not more than five stockholders, and 80% of the company's gross income is from interest, royalties, gains from security and commodity transactions, dividends, annuities, income from estates and trusts, rents received from individuals who own 25% or more of the corporation (directly or indirectly) subject to a limitation that the other personal holding income from nonrental sources is more than 10% of its gross income, and personal service contracts. Rents which don't equal at least 50% of the gross income will also be considered as personal holding company income.

If personal holding income is retained by the corporation, a surtax of between 75-85% will be levied in addition to the regular corporate income taxes.

B.: Massachusetts Filing Fees for Corporation and Federal Stock Transfer Tax

The fee for filing the Articles of Organization of a domestic corporation is one-twentieth percent of the total amount of par value authorized stock, plus one cent per share of no-par stock authorized; but the initial filing fee may not be less than $75.00 in Massachusetts.

The Federal Stock Transfer Tax, collected by stamp sale, is levied at the rate of (a) five cents per $100 or fraction thereof of par value of stock transferred, where the selling price is below $20.00 per share and six cents per share where the selling price is at least $20.00 per share; (b) five cents per share of no-par stock transferred, where the selling price is under $20.00 per share or six cents per share at the price of $20.00 or more per share.

Regardless of the amount of stock to be issued, it is apparent from the above amounts that the costs incurred are nominal when viewed in relation to the total capitalization of the corporation.

C.: Federal Estate Tax Payable Without Deduction for State Credits, With and Without Marital Deduction (Based on Figures Applicable for 1961 Taxes)

Adjusted Gross Estate	Maximum Marital Deduction	Estate Tax Without Marital Deduction	Estate Tax With Marital Deduction
$ 10,000	$ 5,000	$ 500	$ 150
20,000	10,000	1,600	500
30,000	15,000	3,000	1,050
40,000	20,000	4,800	1,600
60,000	30,000	9,500	3,000
100,000	50,000	20,700	7,000
250,000	125,000	65,700	28,200
500,000	250,000	145,700	65,700
1,000,000	500,000	325,000	145,700

The above figures speak for themselves as to the savings occasioned through the use of the marital deduction. It should also be noticed that the estate tax is a progressive tax.

Source: Prentice-Hall Federal Tax Guide, Editorial Volume, Englewood Cliffs, N. J., 1960.

D.: TAX TABLE TO REDUCE TAXES BY DIVIDING INCOME AMONG THE FAMILY: INCOME-SPLITTING (APPLICABLE TO ELECTION AS PSEUDO-CORPORATION AND GIFTING STOCK BY INVESTOR)

Taxable Income*	Tax Reported By Single Taxpayer	Tax Saving of Income Divided In Two	Tax Saving of Income Divided In Three
$ 5,000	$ 1,100	$ 80	$ 100
10,000	2,640	440	560
25,000	10,150	2,920	3,930
50,000	26,820	6,520	10,221
100,000	67,320	13,680	21,342
150,000	111,820	19,480	31,360
200,000	156,820	22,180	38,260

*Generally, gross income, less all exemptions and deductions.

> "A graduated and progressively increasing rate of taxation is and will probably remain a fundamental part of our Federal income-tax system. The higher the taxpayer's income, the greater the amount of such income, percentage-wise, that goes to pay the income tax.
>
> "It is thus readily evident that income tax savings can be achieved by transferring income from a high-income bracket taxpayer to one or more low-income bracket taxpayers. The possible extent of such savings is shown by the (above) table, based on 1958 tax rates (1960 tax rates are similar)."

The availability of a taxpayer to incorporate and then gift a minority interest of the common stock, (since only one class of stock will qualify for the election), is a feasible method by which to dispose of one's interest in the investment during life by gift and not only save current income taxes but also to diminish the estate valuation by taking advantage of the cumulative life-time gift exemption and annual exclusion.

Source: Lourie, G., and Cutler, A. R., How to Reduce Taxes By Dividing Income Among The Family. op. cit., p. 4.

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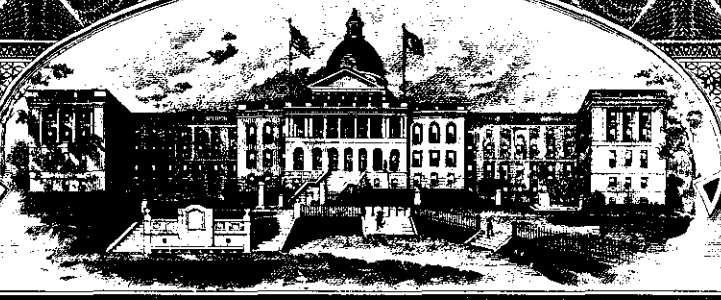
INCORPORATED UNDER THE LAWS OF THE COMMONWEALTH OF MASSACHUSETTS



NUMBER

SHARES

THIS CERTIFICATE IS SUBJECT TO THE RESTRICTIONS SET FORTH ON THE REVERSE SIDE HEREOF

This Certifies that _____

is the owner of _____ Shares of the Capital Stock of

_____

transferable only on the books of the Corporation by the holder hereof in person or by Attorney upon surrender of this Certificate properly endorsed.

IN WITNESS WHEREOF, the said Corporation has caused this Certificate to be signed by its duly authorized officers and its Corporate Seal to be hereunto affixed

this _____ day of _____ A.D. 19__

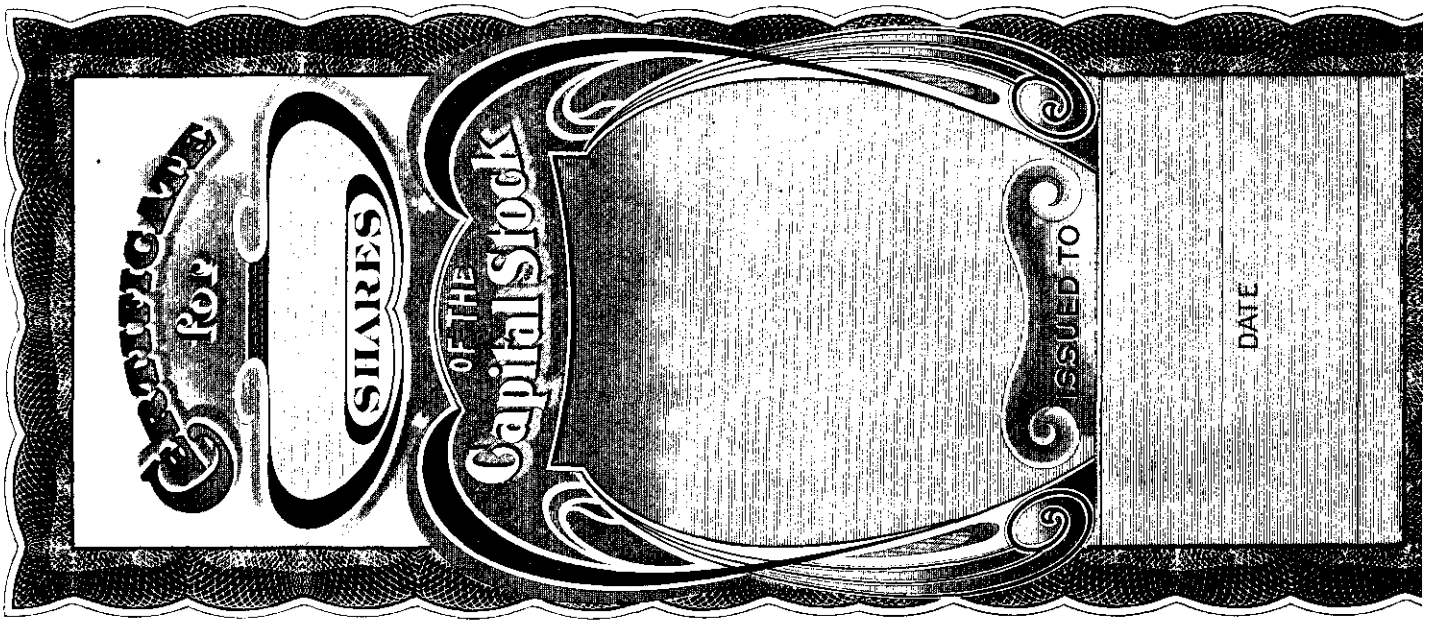
Any stockholder, including the heirs, assigns, executors or administrators of a deceased stockholder, desiring to sell or transfer such stock owned by him or them, shall first offer it to the corporation through the Board of Directors, in the manner following:

He shall notify the directors of his desire to sell or transfer by notice in writing, which notice shall contain the price at which he is willing to sell or transfer and the name of one arbitrator. The directors shall within thirty days thereafter, either accept the offer, or by notice to him in writing name a second arbitrator, and these two shall name a third. It shall then be the duty of the arbitrators to ascertain the value of the stock, and if any arbitrator shall neglect or refuse to appear at any meeting appointed by the arbitrators, a majority may act in the absence of such arbitrator.

After the acceptance of the offer, or the report of the arbitrators as to the value of the stock, the directors shall have thirty days within which to purchase the same at such valuation, but if at the expiration of thirty days, the corporation shall not have exercised the right so to purchase, the owner of the stock shall be at liberty to dispose of the same in any manner he may see fit.

No shares of stock shall be sold or transferred on the books of the corporation until these provisions have been complied with, but the Board of Directors may in any particular instance waive the requirement.

The directors may fix in advance a record date for determining the stockholders having the right to notice of and to vote at any meeting of the stockholders or adjournment thereof or the right to receive a dividend or other distribution or any other rights specified in Chapter 185 of the Acts and Resolves of the Commonwealth of Massachusetts of 1953 and in such case, only stockholders of record on such record date shall have such rights notwithstanding any transfer of stock on the books of the corporation after such record date and all as specified in said statute.



For Value Received, ___ *hereby sell, assign and transfer unto* _____

_____ *Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint*

_____ *Attorney to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises.*

Dated _____ *19*___

In presence of

_____ _____

NOTICE: THE SIGNATURE OF THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THE CERTIFICATE, IN EVERY PARTICULAR, WITHOUT ALTERATION OR ENLARGEMENT OR ANY CHANGE WHATEVER.