Volume 57
Issue 3 *Dickinson Law Review - Volume 57, 1952-1953*

3-1-1953

Partnership or Corporation? (Possible Tax Savings under the 1951 Revenue Act)

Joseph Berman

Daniel S. Berman

PARTNERSHIP OR CORPORATION?

(Possible Tax Savings under the 1951 Revenue Act)

By

JOSEPH BERMAN AND DANIEL S. BERMAN*

The two most important forms of conducting business are the partnership and corporation. The income tax consequences of each form are different. The corporation is treated as a completely separate taxpayer; the partnership is not.

The Revenue Act of 1951 makes it of great importance that attorneys shall become familiar with the act so that they may properly advise their clients to re-examine their form of doing business.

Before the new law came into effect, a corporation may have been the more advisable form, but the new law has swung the balance in some instances in favor of the partnership.

A wise decision requires a correct answer to the following four basic questions:

(1) What form of doing business will channel the greatest amount of business profits into the pockets of the individual owners?

(2) If the present method of doing business is not the best available, what will be the cost of changing it?

(3) Can further tax economies be obtained by subdividing the business into two corporations, into one partnership and one corporation, etc.?

(4) If it is desirable that a change in method be made, how can it be best accomplished to get the greatest tax benefits out of the new form?

* * * * * *

In deciding whether a switch be made the following factors must be taken into consideration:

(1) The important key tax differences; the best salary for stockholder employees; the effect of dividend policy; pension and profit-sharing plans; the effect of state taxes etc.

(2) In switching to a corporation included in it are the advantages and disadvantages of making the switch tax-free, and how it can be accomplished; the best method of capitalizing the corporation; and pitfalls that should be avoided—such as the loss of deductions, personal holding company penalties, the danger of "collapsible" corporations, etc.

(3) In switching from a corporation to a partnership we must look out for the following: (a) the taxability of the switch; (b) the valuation of the good will involved; (c) the excess profits tax danger due to the short year, etc.

(4) The effect of the new family partnership rules.[1]

---

*Members, New York and Federal Bar Associations.

---

1 Commercial Clearing House Revenue, Act of 1951, §§ 121-124, 676-678.

(5) The advantages, taxwise, of using a combination of business forms—such as (several corporations, partnership and corporation, etc.).[2]

(6) Tips in setting up a business to handle foreign trade.

* * * * * *

When a client is in business as an individual proprietor, the owner and his business are considered as one so far as income and taxes are concerned. By incorporating, the individual owner creates another entity with which, he splits his income.

This income splitting feature is the basis of changing business methods, and creates desirability of considering not merely the question of whether clients should be advised to do business as a partnership or corporation; but also as to the possibility of splitting his business into a number of corporations, or using combinations of partnerships and corporations, or forming a family partnership.[3]

The goal should be to work out the balance which, in terms of the earnings of the business and the income bracket of the owner, will yield the lowest total tax. The 1951 Revenue Act has tipped the scales against using the corporate form taxwise. The 5 percent boost which lifted the normal tax rate for corporations to 30 percent makes the corporate form disadvantageous taxwise for any married individual with a net income (before exemptions) of less than approximately $14,000, a single person with less than approximately $7,000, and a head of a household with less than $12,000. For these brackets the lowest corporate rate will be higher than the highest individual rates.

The corporate form should also be avoided by married people with net incomes (before exemptions) of less than $18,000, single people with less than $9,000 and heads of households with less than $14,000. The relatively nominal savings possible at these higher levels most likely would not compensate for the amount of income which must be left in the corporation to produce the savings.

It also is important that we consider, in arriving at a conclusion as to the proper business form, what are going to be the future tax developments. They can be more important than the present tax structure. Tax increases will most likely leave individual and corporate rates in about the same relationship as at present.

The tax cuts slated for 1954 will swing the balance back toward the corporate form if effectuated. This should not raise any problems, if present comparisons indicate that an unincorporated business is best. You can turn to a corporation taxfree in the future if rates are low enough. If a corporation is best now, it will be even better if taxes are cut. Other factors to be considered are governmnt controls over wages,[4] prices,[5] etc.

---

2 See n. 1, supra, §§ 303 and 514A.

3 See n. 1, supra, §§ 92 and 514A.

4 For a full discussion see Berman, "Tax Consequences of the Price Freeze," The Journal of the Bar Association of the District of Columbia (June, 1951) Vol. XVIII, No. 6, p. 230-235.

5 For a full discussion see "Ceiling Pitfalls of Wage Stabilization in the Present Emergency," 56 Dick. L. Rev. 119 (October, 1951).

A corporation may be better taxwise if the client can draw a certain salary, but wage controls may block it, in such case an individual proprietorship may be more desirable.

Price controls also create problems to be considered in making any change in form of doing business, since price rules may prevent the client from carrying over favorable price levels to the new partnership. In such case, the higher profits obtainable as a corporation may outweigh the tax savings as a partnership forced to sell at a lower margin.

Since these controls may last for a long period, it is important to weigh all these factors carefully in deciding on any form of business changes.

Corporations as well as individuals are taxed at rates which start low and run high. Individual rates go from 22.2 to 92 percent, while corporations pay from 30 to 82 percent.[6]

Partnerships and individual proprietorships are not treated as taxable entities separate and apart from their owners. Partnership losses or profits are picked up directly on the tax returns of the partners in proportion to their interests in the business. The sole owner of a business is affected the same way, but stock holders of a corporation don't report their proportionate shares of corporate profits or losses. Only when the corporation pays dividends or liquidates, or its stock is sold or becomes worthless are the stockholders affected taxwise.

There are contrary factors which disturb the perfect tax arrangement of splitting income between corporations and individuals to achieve a minimum overall tax burden. Income left in the corporation will be subjected to additional taxes in the hands of the owner when paid out as regular or liquidating dividends. Therefore, it may not be possible to divide the income exactly as desired. Lawyers must also look out for the penalty for unreasonable accumulations of earnings, state income taxes, etc.

A change in marital status will occasion the necessity of determining a reexamination of the use of a corporation or partnership. The corporation is more advantageous in higher income groups. The higher the business income, the more advisable it generally is to use one or more corporations. If the corporation has to pay an excess profits tax, the corporate rate can still be cheaper than the individuals, since the excess profits tax is not imposed on all income, but only on income reduced by a credit.[7] Every corporation is allowed a minimum credit of $25,000 and the effective rate is always less than the top 82 percent. In addition, total corporate excess profits tax can not exceed a general maximum of 18 percent of excess profits net income (income before credit). For new corporations, the ceiling can be as low as 5 percent.[8]

---

6 See n. 1, supra, §§ 97 and 660.
7 See n. 1, supra, §§ 317 and 768.
8 See n. 1, supra, §§ 318, 108, 821, 319, 321, 772, 774, 315, 312A and 786.

The benefits of operating a corporation are increased if the individual client has income other than from the business itself (dividend, interest, salaries, etc.). It the business is unincorporated its income is piled on top of his outside income and is thereby hit with peak surtax rates. If the business is incorporated, the income left in the corporation will be subject to lower rates.

The choice as to incorporating a client's business or running it as a partnership in order to save taxes should also be governed by the amount of corporate earnings paid out in salary or other expenses to the owners.

A perfect tax arrangement would be to split earnings between the stockholder (in the nature of salary and other deductible expenses) and the corporation (in the form of retained earnings) so divided that the least tax is payable. This can be accomplished by increasing or decreasing salaries paid to the stockholders until the tax rate paid by the stockholder equals the tax rate paid by the corporation.

The ideal salary, however, is not always possible, even if salary stabilization permitted it, since owners may require a higher income for a living. The tax law may not allow it. While there is complete freedom in fixing employees wages or salaries, who are not owners or their relatives, the United States Treasury Department and the courts frown upon it since they are aware of its tax avoidance possibilities by disguising the paid out income as dividends or compensation. Therefore, the Treasury closely scrutinizes it so that it's not a cloak for substitution for dividends. The compensation must be "reasonable" in the light of services actually rendered or it is not deductible. Both the Treasury and the courts are strict where the employee is also a stockholder. It must be "reasonable" depending on its difficulties, importance and responsibility; the time spent on the job, the special training and experience necessary, etc. Additional important factors governing it are the volume of business, size of profits made and the amount of capital used. A salary comparable to that paid for a similar job in a similar business will be generally approved. It is difficult to get such information from competitors. Therefore, it must be guessed.

Commissions, interest, rebates, rents and royalties can be equally valid deductions if paid to stockholders as part of their salary. Such expenses may be what they are purported, "ordinary and necessary."

Partnerships or individual business present no problems in withdrawing profits. Partners can be allowed a "salary," interest on capital, or a bonus; the entire amount credited to a partner is treated as a share of the income. A partner or owner is not considered as receiving a "salary."[9]

Small corporations should not withdraw all or substantial portions of their profits as stockholder expenses unless they are *bona fide*. Over-estimating stockholder expenses can be very costly and lead to double taxation. Profits earned by partners or individual proprietors are taxed only once to the partners or own-

---

[9] See n. 1, supra, §§ 123, 126, 676 and 677.

ers. Profits earned by a corporation are taxed (1) to the corporation, then, (2) when the profits are distributed, the dividends are taxed to the stockholders. A double tax also results where a corporation liquidates or its stock is sold. Profits left in the corporation bear a lower tax but it is "locked," it cannot be used to put children through college, buy a new house, fur coat, boat, summer home, trip abroad, etc. Loans borrowed from the corporation by stockholders may be treated as dividends.

The law frowns on the accumulation and non-distribution of profits by corporations as dividends to stockholders in order to avoid personal taxes. A penalty is imposed in such cases, in addition to the regular corporate tax.

Double taxation also is probable in cases where the corporation is dissolved or the stock sold, and the accumulated corporate profits are reflected in the increased value of assets distributed to stockholders, or in the price obtained for its stock. If an owner contemplates disposition of the corporation in the future, all or part, or more than all of the tax savings previously effectuated can be lost.[10]

On corporate liquidation the tax may be substantially increased if good will or other assets have a low basis, but high value and are originally transferred tax free to the corporation, or good-will is built up by it. On liquidation, the assets are recovered, but a tax must be paid on the difference between the value and the cost or other basis.[11]

In cases where stockholder dies before liquidation or sale is had, a double tax will not occur upon his death. In such cases, the estate tax would have to be paid regardless of the form of business, or regardless of whether the deceased's assets were stock or cash.

Therefore, if the tax savings obtainable by leaving income in a corporation are larger than the additional tax cost of liquidation or sale, incorporation of a business is advisable. Even though the corporate form is subsequently discarded because of changed future conditions, taxpayer will still be ahead of the game.

Where a business has a large amount of exempt income, or capital gains which must be distributed, the tax price of operating as a corporation may be very high. Therefore, when the client incorporates, property producing tax exempt income or capital gains should be left out and the client should retain it individually.

Where a business has long term capital gains and losses it should not be incorporated, (1) since long-term capital gain cannot be subjected to more taxes when realized by the individual and most of the time will be subjected to a less tax, and (2) since capital losses of a corporation cannot be used to offset other income of the corporation or any capital gains which the stockholder may have. But capital losses of partnership become the partner's capital losses and can be used by him to offset personal capital gains.

---

10 See n. 1, supra, §§ 197 and 618.
11 See n. 1, supra, §§ 198 and 619.

Only 15 percent of corporate dividend receipts received by a corporation from domestic or certain foreign corporations subject to income tax are taxable for income tax purposes, and are completely exempt from excess profits tax.

A corporation can only invest a very limited amount in outside securities without subjecting itself to the penalty for unreasonable accumulation of earnings and possibly the personal holding company penalty.

Corporate losses cannot be used to offset any other income that the stockholder may have. Therefore, it is (except for carry-over and carry-back provisions) a tax waste. Losses by a partnership can be applied to reduce personal income of the partner. This is of importance only where an individual has sources of income outside his business. A working stockholder's salary is subject to payroll tax, i.e., Old Age Insurance Tax and Unemployment Insurance Tax.

Corporate stockholding employees can become beneficiaries of deferred compensation plans, whereas working partners or a sole proprietor cannot.

Sole proprietors and partners pay their taxes as income is earned but corporations have a full year's use of the tax money since they pay taxes in quarterly installments the following year.

Corporations losing money in a succeeding year can immediately reduce the amount of payments due on their previous year's income through the carry-back and the quick refund adjustment, whereas a partner or individual will have to wait for his refund.

The acquisition of loss corporations can cut taxes, if the deal was not entered into principally to avoid taxes.

An individual property owner with property or inventory appreciated in value can subject it to a long term capital gains tax and thereby save it from ordinary income taxes by incorporating his business, and selling the stock. There is one pitfall that must be avoided in such cases—the "collapsible" corporate provision of the tax law. In addition, capital losses can be used to the extent of $1000 yearly, to offset partner's other income.

Before the clients are advised in the cases above mentioned it is necessary to make a tax comparison calculating the full annual tax bill of the same business operating as (1) a corporation and as (2) an unincorporated business.

All actions in these cases must be planned—religiously following the law, rules and regulations, if the clients are to reap the full benefit of switches calculatingly made.

There are instances where it is advisable to start the business as a partnership so that early partnership losses are taken advantage of by the individual taxpayer and so that the same losses also can be used to reduce future corporate profits.

If the venture is unprofitable and abandoned, the entire loss can be used to offset personal income and can be carried backward or forward as a business loss. Under corporate form, only a restricted amount of the loss is deductible (as a capital loss from worthless stock or from liquidation).

The operation in its inception for a limited period as a partnership can be used as a test in comparing estimated income with actual income, since incorporation must be based on estimated future earnings and future tax conditions. If actual earnings do not live up to expectations or if the tax climate changes, there is an opportunity to change plans without tax cost, or postpone incorporation until earnings meet estimates.

An individual or a partnership can transfer property to a corporation without a taxable gain or loss, if (1) partners after exchange have at least 80 percent of outstanding voting stock and at least 80 percent of total number of shares of all other classes of stock of the corporation, and (2) the amount of stock and securities received by each partner is in proportion to the interest he had in the property before the exchange for stock.

The change from a partnership to a corporation can be accomplished without resulting in any gain or loss (1) by dissolving the partnership turning over partner's interests in the assets to the corporation in exchange for its stock, or (2) by transferring partnership assets to a corporation organized for that purpose in exchange for its stock, then distributing its stock to the partners.

The best way to transfer appreciated property is by retaining it in the partnership and lease it to the corporation for limited time periods. This minimizes the risk for heavy taxation on liquidation and permits income splitting through rent payments to stockholders. Attorneys can advise that the same procedure be followed in the case of transfer of partnership good-will.

The transfer of depreciated property or assets to a corporation depends on (1) whether an individual can use the loss to offset other income, (2) whether the loss would be a capital or ordinary loss, or (3) whether the corporation could gain a greater tax advantage by offsetting the loss against income.

What are the tax savings that can be effectuated in incorporating a partnership? Partnership assets that are distributed to partners, who subsequently transfer them to a corporation in a tax free switch must be refigured by following this rule:

> (1) Each asset should carry its proportion of the partner's former basis in the firm which the value of the property transferred bears to the total value of all the partnership assets at the time of distribution to the partners. This reallocation rule can yield definite tax savings.[12]

In some instances it may be wise to make an incorporation taxable before deciding on it, however, the attorney must remember the risk taken in connection with good-will. In such cases he may find his client saddled with a much greater capital gains tax than expected. A loss on a taxable transfer of assets will not be allowed in such cases.

Penalties on unreasonable accumulated earnings are imposed when (1) there is a substantial amount of accumulated earnings, and (2) there is an undue

12 G.C.M. 20251, C.B. 1938-2, 169 Everett N. Crosby 46 B.T.A. 323.

amount of liquid assets or extraneous investments. The second occurrence can be minimized or eliminated by undercapitalizing the new corporation.

Two advantages can be obtained by using bonds for part of the new corporate capitalization (1) since the interest paid on the bonds is deductible and (2) since redemption of the bonds is tax free and income of the corporation can be siphoned off in that way.

When a corporation is first organized, it is important that proper apportionment be made between stocks and bonds, since an established business does not have such freedom. A functioning corporation attempting to replace part of its stock by bonds would be subjected to heavy tax penalties where the relative equity ownership of its stockholders remains substantially unchanged.

None of the corporate obligations issued should have the earmarks of preferred stock, otherwise interest deductions will be disallowed.

The bonds should provide that interest and principal payments are to be made regardless of the financial condition of the corporation or its profits. Interest payments made dependent on profits or other conditions will be treated as dividends.

The Tax Court treated bonds as stock where the ratio of bonds to stock was top-heavy. It recognized as valid debts amounts equal to four times the equity capital.

In reorganization cases, the court ruled that only long term bonds qualify as securities. Therefore, it can incorporate with long-term bonds and make them callable in whole or in part on certain X days notice. This method usually accomplishes the desired tax purpose and still retains the desired status of the security issued.

Bonds with increasing redemption value can result in attractive tax savings. The increased price in such cases is considered a capital gain and not interest.

There are three-fold tax breaks:

(1) An accrual basis corporation can obtain the tax benefits represented by the yearly increase as though the interest was paid.

(2) A cash basis bondholder does not pay tax on the increment until the bond is redeemed, which may be any number of years later.

(3) The corporate indebtedness is shown by a bond, debenture, note, certificate or other evidence of indebtedness in registered form.

The proper use of this kind of bonds converts what would be ordinary interest income into a capital gain.

Taxwise, preferred stock is not a desirable method of corporate financing. The government in effect pays a goodly part of the interest on bonds while the corporation bears the whole burden of dividends on preferred stock.

A state tax saving can result from issuing a small amount of capital stock, and allowing the remaining investment to show up as paid-in surplus. It also results in transfer tax savings and in some instances saves double stamp taxation. Increase in capitalization can subsequently be accomplished tax free through the issuance of stock dividends.

A tax-free transfer to a corporation may result in the loss of a tax deduction if the unicorporated business had contingent liabilities or contested ones at the time of incorporation.

If an attorney has any clients who desire to incorporate any business with liabilities nondeductible until paid or settled, he should have them follow this procedure:

> (1) Retain enough assets in the unincorporated business to liquidate the liabilities, (2) give all other assets and liabilities immediately to the corporation, (3) have them continue the old business long enough to pay the debts. (the individual owners can then get the benefit of the deduction), (4) transfer any remaining assets after liquidation of debts to the corporation.

Possible bunching of many years income into the incorporating year should be avoided as well as pyramiding of income—by letting the unincorporated business finish its contracts and liquidate its accounts receivables.

A corporation which grew from a partnership can use the partnership earning history in arriving at its excess profits credit if the incorporation is tax-free. Part credit can only be obtained where part of the business is transferred. A corporation formed from an individual proprietorship gets the same break as a tax-free incorporation only if practically all the assets of a separate business are incorporated.

These breaks cannot be obtained if the incorporation is a taxable one made after December 1, 1950.

New corporation ceilings of 5-14 percent are available to unincorporated business in existence for many years. But in the case where the individual proprietorship or partnership was the outgrowth of an earlier corporation, the Treasury may attempt to trace the taxpayer's first year back to the earlier corporation.

If a corporation is formed, the attorney should see that it does not fall into the personal holding company pitfall (which often traps taxpayers) where land, building and business are owned by sole proprietor or partnership. If the land and building is transferred to a corporation, and the unincorporated business pays the rent to the corporation, the corporation qualifies as a personal holding company and is subjected to a special tax.

* * * * * *

The new law tries to bar the conversion of ordinary income into capital gains through the use of a temporary collapsible corporation. But under court decisions and the latest rules of the Internal Revenue Bureau when a partner sells his interest in a partnership business, the gain thereof will be treated as a capital gain.

Since good-will can be an important factor in arriving at the tax payable upon corporate dissolution, the method used in arriving at dollar value for good will is important.[18]

The formula used by the Treasury determines good-will by capitalizing earnings attributable to it, as follows:

(1) Determine the average annual net earnings of the business.

(2) Ascertain the value of the tangible and intangible assets such as copyrights, patents, trademarks, etc.

(3) Deduct from the average net earnings a fair rate of return on the tangible and intangible property.[18a]

(4) Capitalize the balance.

In determining the average annual earnings, the period chosen should be representative of the earning ability of the enterprise, and should fairly reflect the probable future earnings. Periods ranging from 3 to 14 years were approved. The rate of return on tangible and intangible assets, and a reasonable rate for capitalizing the remaining earnings will vary with the type of business involved.

The Treasury does not have its own way in connection with valuation of good will. The Tax Court gives the taxpayer a helping hand since (1) the Commissioner must show that there is transferrable good-will attached to the business, and since (2) the Tax Court has often used a lower figure than the valuation way of the formula provided by the Treasury.

In dissolving a corporation the proceeds of life insurance policies may lose their tax exempt status. The proceeds thereof are generally tax exempt.[13b] Non-stockholder-employees policies distributed on liquidation of a corporation are not fully tax-exempt. The amount taxable is the proceeds minus the value of the policy at date of dissolution and the premiums subsequently paid.

In the case of employee-stockholders, different rules apply and the transfer of a policy to the insured does not affect the tax-exempt characteristics of the proceeds (1) where the policy is on the sole stockholder, the distribution of it to him would not make future proceeds taxable. (2) If the policy transferred to the successor partnership is on the life of only one of a number of stockholders, the future proceeds would be taxable only as the share belonging to the uninsured partners. The transfer of a policy from an unincorporated business to a corporation in a tax-free transfer does not change the tax-exempt nature of the insurance proceeds. The incorporation of the business does not face the problems involved in corporate dissolutions.

---

18 For a full discussion see Berman "Valuation of Annuities," Business interests, Copyrights, Goodwill, Life Insurance etc."

18a For a full discussion see Berman, "Valuation of Property for Estate, Gift and Income Tax Purposes," Chicago Kent Law Review, vol. 29, No. 4 (September, 1951); Lawyer and Law Notes, (Winter, 1952); The Monthly Digest of Taxes, (January, 1952).

13b For a full discussion see Berman, "Federal Tax Advantages Derived under Proper Planning of Life Insurance and Annuities," Mississippi Law Journal, 23:210-22 (May, 1952).

In changing from a corporation to a partnership, the tax-exempt character of the life insurance proceeds can be maintained if the old policy is cancelled and a new one is taken out by the partnership. This is not always advisable, since the insured may not be insurable, the old policy may contain unobtainable provisions and a substantial loss is caused by the cancellation, etc.[14]

Election to postpone tax on liquidation can be advantageous where corporate property increased substantially in value or where a good deal of good-will was created and the accumulated earnings and profits are small. The individual election to postpone part of capital gain has its penalty since it converts part of capital gain into a fully taxable dividend.

Corporate dissolutions which take place other than the last day of taxable year result in a short year return and must be placed on annual basis for excess profit tax purposes and not for income tax purposes. This often results in larger taxes than if dissolved at the end of the year.

The client's carry-over and carry-back status must be considered before a final decision is made as to form of doing business. High taxes represent usually a form of an insurance reserve against future losses. Losses of corporations and individuals can be carried back one year or forward for five years. A change in business form may forfeit the reserve represented by previous years' tax payments. Only the identical taxpayer can carry back losses. Unused losses can, still be carried forward.

Change in business form also can cause possible loss of merit rating. In changing business form do not leave loose ends since they can lead to litigation and may endanger its recognition as such.

A new business is free to select any taxable year provided it closes its books on that basis, and does not have to get the Bureau's consent for it.

The 1951 Revenue Act reinstated the gift-created family partnership as a major tax-saving device. The following standards are required:

> (1) The donee partner's interest must be really his and not merely a sham transfer, (2) the division of profits must allow a reasonable allowance for personal service rendered by donor partner and (3) the share of the profits allowed to the donated capital must not be greater than the share allocated to the donor's capital.

Partnerships with children can save taxes, since (1) income taken out of higher brackets of the married couple to the lower rates applicable to the smaller income of their children, or other members of their family. (2) If income shifted to children is under $600 for each, the entire shift will be exempt. (3) As a result of optional standard deduction, 10 percent of all income (up to $10,000 a year) shifted to a child is exempt from tax.

---

14 See n. 1, supra, §§ 196 and 620-622.

It not only saves income taxes but also estate taxes to the donor. The 1951 Act makes spin-offs easier transactions between related corporations. They should be handled as though they were dealings between strangers.

The use of both corporations and partnerships, if properly set up, can save taxes. Personal service domestic corporations may elect to be exempt from excess profits taxes, but their stockholders will be taxed on their *pro rata* share of the net income of the corporation remaining after the payment of income taxes. To qualify as a personal service corporation the following requirements must be met. (1) Its income must be derived primarily from the activity of its shareholders who own at least 70 percent in value of each class of stock during the year. (2) Its shareholders must be engaged regularly in the active conduct of its affairs, in addition to the proceeds from it being the primary source of their income. (3) Capital must not be a material income producing factor.

Domestic corporations engaged in foreign trade are exempt from excess profits tax if (a) 95 percent of its gross income for 3 years immediately preceding the taxable year was derived from sources outside the U. S., or if (b) 50 percent or more of the gross income for that period was from the active conduct of business.

The excess profits exemption will be lost if the new corporation files a consolidated return with affiliated non-exempt corporations. Western Hemisphere trade corporations obtain tax benefits by the 1951 Revenue Act. They are exempt from excess profits taxes and get a special credit for both normal taxes and surplus tax purposes of 27 percent of the normal tax net income. In order to qualify they (1) must do all their business in North, Central or South America, or in the West Indies, or in Newfoundland, (including Puerto Rico),[15] (2) at least 95 percent of their gross income for the 3-year-period preceding the close of the taxable year must have been derived from sources outside of the United States, and (3) at least 90 percent of its gross income must have been derived from the active conduct of a business or trade.

A Western Hemisphere corporation is subject to a maximum of 37.96 percent. Small business corporations may have as low a tax as 21.9 percent. Income from this country's possessions get capital tax benefits under the following conditions (1) where 80 percent of the corporation's gross income for the 3-year-period immediately preceding the close of the taxable year was derived from sources within a possession or (2) where 50 percent of its gross income was derived from actual conduct of a business or trade within a possession. For an individual the trade or business can be either on his own account or as an employee or agent of another.

[15] See n. 1, supra, §§ 95 and 518.