THE SUBCHAPTER S CORPORATION

A Tax Hybrid

An Honors Thesis

ID 499

By

Donna Jean Flanders

Thesis Director

Robert W. Walker

Mr. Robert W. Walker

Ball State University

Muncie, Indiana

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The 16th Amendment to the Constitution, ratified in 1913, permitted taxation of income "from whatever source derived." The related Revenue Act of 1913 imposed a tax on all corporate income at a rate of 1 percent. This Act also levied a "progressive" tax on individual income of 1 percent of taxable income in excess of $3,000 up to 7 percent of taxable income in excess of $500,000.[1] These measures created the necessity of considering the effects of taxation when selecting the form for a business enterprise.

A corporation is often a preferred form of business enterprise in that it is considered a legal entity with free transferability of shares, limited liability, perpetuity of existence, and centralization of the management functions. The major drawback to the corporate form of enterprise is the fact that the corporation is taxed on its earnings, and the individual shareholder is also taxed when these earnings are distributed to him, resulting in double taxation of earnings.

To help stimulate small businesses, encourage investment in new ventures which are either small or have prospects of large initial losses, and lessen the importance of taxation in selecting the form of business, the Congress passed and President Eisenhower signed the Technical Amendments Act of 1958, which contained the Subchapter S provision, now incorporated as Sections 1371-1379 of the Internal Revenue Code. This provision allowed certain "small business" corporations to be taxed in a way similar to partnerships, but considered in every other way a corporation. The corporation elects not to pay tax on its earnings, rather, allowing the burden of paying taxes fall directly upon its shareholders for the entire amount of its earnings, whether or not distributed to them.

Today, one of every nine corporations files income tax returns under a Subchapter S election, less than one half of the number of corporations eligible to do so.[2] With recent changes in the law, many more corporations have become eligible for the status, and several additional corporations are expected to elect Subchapter S corporation status.

It is the intent of this paper to discuss the eligibility requirements for Subchapter S corporation status and reasons for past changes in them, explain how election of such status is made, how termination of such election occurs, and the effects of such election on the taxation of corporate income. This paper will also identify the disadvantages and advantages of Subchapter S corporation status for business enterprises.

Eligibility Requirements for Subchapter S Status

To be qualified to elect Subchapter S status, a corporation must be a domestic corporation which is not a member of an affiliated group eligible to file a consolidated tax return with any other corporation. In order to be permitted to file a consolidated tax return, 80 percent or more of each corporation in the group, except the parent, must be owned by other corporations within the group. Owning stock in another corporation that has not begun business during the taxable year and has no taxable income for the year, however, does not disqualify the parent corporation from electing Subchapter S status.[3]

The corporation may not have more than 25 shareholders during taxable years beginning after December 31, 1981. For taxable years beginning before 1982 and after December 31, 1978, the business could not have more than 15 shareholders. For tax years starting after 1976 and before 1979, the corporation could have up to 15 shareholders if the corporation had had Subchapter S status for a period of at least five consecutive years, and if during this period the number of shareholders exceeded 10 but not 15, solely by the reason of additional shareholders who acquired their stock through inheritance, the additional shareholders may equal the number by which the inheriting stockholders caused the total number of stockholders to exceed 10. Prior to 1977, the number of stockholders of a Subchapter S corporation could never exceed 10.[4]

For purposes of determining the number of shareholders, ownership by more than one person as joint tenants, tenants in common, or tenants in the entirety counts as ownership by one person. Husband and wife are always counted as one shareholder, regardless of the type of ownership. This removes the discrimination against corporations with shareholders in community property states where a married shareholder counted as two shareholders, since the spouse, by state law, owned one half of the stock.

The limit of ten stockholders was originally set for administrative simplicity and to limit benefits to mainly small, family-owned-and-operated businesses. Because of the complex rules of the shareholders paying tax on the corporation's income, the Department of the Treasury wanted experience in dealing with such corporations on a small, relatively simple scale. The exception of allowing up to 15 shareholders when it was the result of inheritance was made to facilitate estate planning and make the continuance of the Subchapter S election easier after the death of a shareholder. These limits, however, proved to be unnecessarily strict and constituted a barrier to the financing of some ventures and the inclusion of some investors in other ventures. With inflation, it became difficult to obtain all of the necessary capital from the owner-operators. By increasing the limit to 15 shareholders for all Subchapter S corporations, Congress increased the opportunity for financing by people other than the operators, sources such as family and friends. With the increase of the limit to 25 shareholders in the Economic Recovery Act of 1981, more outside financing sources may be used to finance a business' ever growing need for capital, and thus encourage greater use of this form of business entity by eligible corporations.

Note, that while there is a limit on the number of shareholders, there is no limit on the total amount of equity or assets. Thus, large as well as small corporations may qualify as Subchapter S corporations as long as they meet the limit on the number of stockholders.

All shareholders of a Subchapter S corporation must be either individuals, decedents' estates (but not a bankrupt individual's estate), a qualified Subchapter S trust for taxable years beginning after December 31, 1981, or, for tax years beginning after 1976, a grantor trust, if the grantor owns the trust for tax purposes and is an individual citizen or United States resident, a voting trust, or any trust that receives stock pursuant to the terms of a will, but only for a 60-day period beginning on the day which the stock was transferred to it.[5]

A qualified Subchapter S trust is a simple trust which owns stock in one or more Subchapter S corporations. The terms of such trust must allow only one income beneficiary at a time, who is a citizen or resident of the United States. All of the income of a qualifed Subchapter S trust must be distributed currently to such beneficiary and the corpus, if distributed during the term of the trust, must be distributed only to such beneficiary. Each income interest terminates on the earlier of the death of the income beneficiary or on the termination of the trust. If the trust terminates during the life of an income beneficiary, the trust must distribute all of its assets to such beneficiary. The beneficiary must elect to have the Subchapter S trust rules apply, and each election must be made separately for each Subchapter S corporation in which the trust has stock, and separate election by each subsequent income beneficiary is required. The beneficiary is treated as the owner of the stock.[6]

A grantor trust after the grantor's death remains eligible as a stockholder for a two-year period if the entire trust is included in the estate. If it is not entirely included, it only remains eligible for a 60-day period following the grantor's death.[7]

A voting trust is a trust that is created primarily to exercise the voting power of the stock transferred to it. For purposes of determining the number of shareholders, each trust beneficiary counts as one shareholder.[8]

No stockholder of a Subchapter S corporation may be a nonresident alien.[9]

In order to be eligible, a corporation may only have one class of stock.[10] This rule was made to eliminate the difficulties of allocating income to different classes of stock. In order to be considered as having only one class of stock, all stock must have equal rights, including voting rights.

The corporation may not receive more than 20 percent of its gross receipts from interest, dividends, rents, royalties, annuities, and gains from the sale or exchange of securities. Gross receipts from the sale or exchange of stock or securities do not include amounts received as payments in exchange for stock in the liquidation of a corporation more than 50 percent owned (each class of stock) by the electing corporation. A gain from the sale of real estate is not subject to the 20 percent limit. "Gross receipts" is the total gross amount received or accrued under the corporation's accounting method. The limit on passive income is not applicable if "passive" investment income is less than $3,000 and it is during the corporation's first two years of business.[11]

The limit on passive income was meant to prevent election of Subchapter S status by personal holding companies. The exception for companies during their first two years of business is intended to keep a new corporation from losing its special election at the very beginning of its existence.

The final eligibility requirement is that the corporation may not receive more than 80 percent of its gross receipts from sources outside the United States.[12]

Election of Subchapter S Status

Election of Subchapter S status is accomplished by the unanimous consent of shareholders of record on the day election is made. The election is made on Form 2553 which is then signed by an officer authorized to sign the Small Business Corporation tax return. Each shareholder must sign an individual statement of consent and Form 2553 must be filed.[13]

In order for the election to be effective for a given taxable year, the election must be made at any time during the preceding year or at some time during the first 75 days of the given taxable year. Once the election is made, it is effective for the taxable year of the corporation for which it was made and for all succeeding years, unless it is terminated. As long as a corporation has a valid Subchapter S election, it is not subject to corporate income tax. It still must, however, file a return, Form 1120S, annually showing income deductions, shareholder information, and distributions made to shareholders.[14]

If the corporation has property subject to investment tax credit recapture at the time of election, such recapture occurs unless the shareholders and corporation file an agreement stating that the shareholders will be liable for any recapture during the period of election. The shareholders cannot, however, share in any investment tax credit carried forward or back from non-election years.[15]

Termination of Subchapter S Election

Termination of the Subchapter S status may occur in a variety of ways. While the actual consent of a new shareholder is not required, the new shareholder, who was not a shareholder on the day of election, may affirmatively refuse to consent to such election by the 60th day after he acquired the stock, thus terminating the election. If the new shareholder is an estate of a decedent, it must affirmatively refuse by the 60th day following the earlier of the day on which the executor or administrator qualifies, or the last day of the taxable year in which the decedent died in order for such refusal to be effective. This type of termination is effective for the taxable year in which the person becomes a shareholder, or if later, the first taxable year the election would have taken effect, and all succeeding taxable years.[16]

The above provision was designed to prevent the election from being lost merely due to oversight. If the shareholder does not want the Subchapter S status, he must take action to terminate it. Otherwise, it remains in effect.

The Subchapter S status may be revoked by the unanimous consent of shareholders on the day revocation is made. This termination is effective for the taxable year in which it was made, if made within the first month of the taxable year, or, if made later, for the succeeding taxable year. Once made, the termination is effective for all ensuing taxable years.[17]

The election may be terminated involuntarily by failing at any time during the taxable year to meet all of the eligibility requirements. The termination is effective for the taxable year in which the requirement was not complied with by the corporation, and all following taxable years.[18]

Once a Subchapter S corporation status has been terminated or revoked, a new election by the corporation or successor corporation cannot be made until the fifth taxable year following the year in which the termination was effective, unless the expressed consent of the Secretary of the Treasury is obtained.[19] This limitation on re-election was designed to prevent corporations from fluctuating back and forth on Subchapter S status to have the best of both corporate and partnership status for taxation, depending on their current income situation.

Taxation and Distribution of Subchapter S Corporation's Income

A Subchapter S corporation's income is taxed similarly to a partnership's income, but important differences are present. While the Subchapter S corporation basically acts as a conduit for income, there is no tracing of most special types of income, deductions, exclusions, and credits through to the shareholders, to make it simpler for the Treasury. Net capital gains, net operating losses, and the investment tax credit do, however, flow through to the shareholder.

Current income distributed in the form of money is taxable to the shareholder in the year of receipt. These dividends do not qualify for the dividend exclusion, nor do they qualify for consideration in the calculation of the credit for the elderly. Dividends paid from net long-term capital gains retain their status in the hands of the stockholder.[20]

Undistributed taxable income is taxable income minus the sum of capital gain taxes paid by the corporation, the amount of any minimum tax paid on tax preference items, and the amount of money distributed out of current earnings and profits. This amount is taxed as if it were a dividend distributed to each shareholder on the last day of the taxable year in his porportionate share. This increases the shareholder's basis in his stock by such amount. Taxable income is determined without regard to any net operating loss deduction or the dividends received exclusion.[21]

Money distributions (to entities who were shareholders at the close of the prior year) during the first two and one half months following the end of the taxable year are considered distributions of previously taxed income to the extent of the prior year's undistributed taxable income. Therefore, such distributions are not taxed at that time to the shareholder, since the earnings were taxed as undistributed taxable income. These distributions are not considered dividends and, ergo, do not reduce the current year's undistributed taxable income for shareholders. This distribution reduces the stockholder's basis, if such basis had been increased earlier by the constructive dividend. This grace period was allowed to let the corporation determine its true earnings for the year and then distribute the income to its shareholders. This treatment is permitted even if the Subchapter S election is not in effect in the following year.[22]

Previously taxed income cannot be otherwise distributed unless all of the current year's earnings and profits have been paid out in cash. Any amounts paid out in excess of the current year's earnings and profits are tax-free only to the extent of the shareholder's net share of previously taxed income. Any amount in excess of the shareholder's net share are treated as dividends and are taxable if covered by accumulated earnings and profits. If not, it is considered a return of capital, tax-free up to the basis of the stock, and considered a gain on all of the remainder. A shareholder's net share of previously taxed income is equal to the sum of the amounts of undistributed taxable income included by the shareholder in his gross income for all prior taxable years under election less the sum of his allowable share of net operating losses and all amounts previously distributed as previously taxed income.[23]

The shareholder's right to previously taxed income is personal and cannot be sold or transferred. This right is lost only if all shares are transferred. If the election is terminated, distributions of previously taxed income, except amounts transferred under the two and one half months rule, are taxable again to the shareholder to the extent they are covered by earnings and profits.[24]

Net capital gains maintain their special status in the hands of the shareholder, whether or not distributed. Such net capital gain is not allowed to exceed the corporation's taxable income. The gain shall be reduced by the amount of taxes paid on the net capital gain and any taxes paid on tax preference items.[25]

The corporation must pay a tax if the net capital gain of the corporation exceeds \$25,000 and exceeds 50 percent of its taxable income for such year and such income for the corporation for the year exceeds \$25,000. The amount of the tax will be equal to the lesser of the alternative capital gains tax rate (28%) times the amount by which the net capital gain exceeds \$25,000 or the amount of tax payable on the capital gain if the corporation was being taxed under the normal corporate rates.[26] This tax is not imposed if the election for Subchapter S status has been in effect for the immediate three preceding years or if the corporation has been in existence for less than four taxable years and an election has been in effect for each of these taxable years. Even if the corporation need not pay capital gains tax because of the aforementioned exceptions, the capital gains tax will be imposed on a gain from property acquired from a nonelecting corporation during a 4-year period ending on the last day of the tax year the property is disposed of, and if the basis is derived from property in the hands of a nonelecting corporation during the entire period.[27] This imposition of tax on the corporation was to discourage a corporation from electing Subchapter S status merely as a means to pass through as a capital gain a gain on the sale of a sizeable asset and also avoid double taxation.

Net operating losses also maintain their special character in the hands of the shareholder. The deductible amount is equal to the shareholder's pro rata share of the sum of the corporation's daily net operating loss attributed on a porportional basis to the shares held by him on each day of the taxable year. Thus, it is passed through to shareholders at any time during the year. The shareholder's share of the loss may not exceed the adjusted basis of the shareholder's stock and the adjusted basis of any indebtedness of the corporation to the shareholder. This loss will be allowed as a deduction attributable to a trade or business from the gross income of the shareholder.[28]

Investment tax credits resulting from acquiring equipment during the taxable year are passed through to the shareholders in their pro rata share as of the last day of the taxable year.[29]

The shareholder's basis in his stock is equal to his initial cost plus amounts of undistributed taxable income included in his gross income increased or decreased by any adjustment of such amount in any re-determination of the shareholder's tax liability. The basis is also reduced by distributions of previously taxed income and by the shareholder's pro rata share of the corporation's net operating losses as long as the basis is not reduced below zero.[30]

The basis of indebtedness to the shareholder is reduced by the shareholder's share of the corporation's net operating loss in excess of his adjusted basis in the stock of the corporation.[31]

Certain special rules do apply to retirement plans of Subchapter S corporations. The plan is not qualified unless forfeitures cannot benefit a shareholder-employee who owns more than 5 percent of the outstanding stock of the corporation at any time during the taxable year. A shareholder-employee must include in his gross income the excess of the contribution by the corporation over the lesser of 15 percent of compensation earned by him from the corporation or $7,500. This excess is not taxed when subsequently paid to the shareholder-employee. Any excess of the amounts included in gross income over the total payments received is deductible by the shareholder or his beneficiary when the payout period ends. There is no carryover allowed of the unused portion of the excess of deductible contributions over the limitation to a taxable year when the electing corporation is no longer under the election.[32]

Disadvantages of the Subchapter S Election

The main disadvantage of a Subchapter S election arises when the corporation earns high enough profits to cause the applicable individual tax rate to exceed the corporate tax rate. Another major disadvantage is that unlike partnerships, the Subchapter S corporation is not a true conduit; that is, special characteristics of some types of income and deductions are not retained in the hands of the stockholders. Tax-free income to the corporation, such as interest on municipal bonds and life insurance proceeds, is taxable to the shareholder. Also, the dividend exclusion for dividends received from domestic corporations is not passed through to the stockholders.

The complexity of the Subchapter S statutes poses a barrier to many corporations. For corporations that expect to begin realizing profits in a short period of time and do not expect to realize sizeable losses, the expense of required advice and the difficulties experienced in trying to set up and maintain a Subchapter S election make seeking such status hard to justify. Additional complications arise when state tax laws do not recognize small business corporations for income taxation purposes, thus requiring two different types of accounting for income tax determination. In corporations with a diverse group of stockholders, it may be very difficult to obtain unaminous consent of the stockholders necessary to elect Subchapter S status. Possible sources of capital are limited since other corporations and partnerships are not allowed as shareholders.

While net operating losses are passed through to the shareholder, the deduction of such losses is limited to the shareholder's basis. Any amount in excess is "lost " and cannot be carried back or carried forward. This disadvantage can be minimized by making loans to the corporation to increase the shareholder's basis during a year that a net operating loss is expected in order to ensure enough basis to fully absorb the shareholder's share of the net operating loss.

While net operating losses pass through to shareholders, net capital losses are not passed through. Capital losses can only be carried forward for five years to offset capital gains, afterwhich they are lost.

Net long-term capital gains retain their character when passed through. Short-term capital gains and losses are netted into the taxable income of the corporation. Thus, they are not available to offset the individual's short-term gains and losses on other transactions.

The Subchapter S election makes it relatively simple to transfer income within the family by transferring stock at year end. Operating losses cannot be shifted since they are apportioned on a daily basis, and the amount attributable to a person is based on the length of time he held the stock, instead of whether or not he was the owner at year end.

A Subchapter S corporation does not operate as a tax shelter for tax preference items, such as accelerated depreciation, capital gains, stock options, depletion, and intangible drilling costs. These items are passed through and apportioned among the shareholders in the same manner as net operating losses.

Another difficulty arises in the fact that the Subchapter S election may be involuntarily and retroactively terminated if one of the stringent requirements is not complied with at any time during the year. The election can be easily lost due to oversight, resulting in serious tax consequences because of tax planning efforts based on the Subchapter S status.

Advantages of the Subchapter S Election

The principal advantage of the Subchapter S status occurs when the income attributable to the owners is small, and their other income is significantly low to allow the applicable individual tax rates to be lower than the corporate tax rates, resulting in a lower tax liability. Subchapter S status is advantageous when a new venture is expected to operate at a loss for the first few years since net operating losses and investment tax credits are allocated directly to the shareholder. This permits high bracket investors to offset their personal income by the corporation's operating losses, thus allowing them to recover a large part of their investment by tax savings. Also, there is no double taxation of the corporation's earnings.

The typical advantages of a corporation also are attributable to a Subchapter S corporation. Limited liability makes it easier to raise capital for high risk ventures, especially if family and friends are looked to for capital, and they are not willing to risk their entire personal worth. The sale of stock makes it easier to transfer and dispose of business interests, and any gain realized is treated as a capital gain instead of ordinary income. Centralization of management and continuity of existence after the death of an owner are also characteristic of a Subchapter S corporation. Employee incentive can be increased by stock ownership plans. Fringe benefits, such as pension plans, stock options, deferred pay plans, group life, disability, hospitalization, and major medical insurance, and death benefit payments, are available for the shareholder-employee and are deductible in arriving at taxable income.

Subchapter S status makes it more permissible to retain earnings in the business since the shareholders are taxed on their prorata share of earnings of the corporation, whether or not distributed. A Subchapter S corporation is, therefore, not subject to the surtax on improper accumulation of earnings.

The Subchapter S corporation can elect its own accounting year irrespective of the accounting years of its shareholders, which may be used as a vehicle to defer payment of taxes on the corporation's earnings. Since the corporation's undistributed income is considered as constructively received on the last day of the taxable year, the earnings are not considered taxable to the shareholder until that time. Therefore, if a corporation ends its fiscal year on January 31, the calendar-year shareholder does not have to pay taxes on that income until a year after the following April -- a deferral of about 14 months.

It is relatively simple to transfer income to lower-bracket family members under a Subchapter S election. By transferring the shares of stock to such a family member a few days before the end of the taxable year, the transferee receives that stock's share of corporate income earned during the entire year. The Treasury will require, however, that the family member active in the business be paid reasonable compensation for his services.

To avoid the collapsible corporation rule, a Subchapter S election should be considered. Instead of liquidating or selling the corporate stock, let the Subchapter S corporation sell the assets. Then where the collapsible rules would ordinarily operate to turn the capital gains into ordinary income, the corporation would realize capital gains which would be passed through to the shareholders in such a state.[33]

Subchapter S corporations can combine the benefits of a 12-month liquidation and installment sales reporting. The shareholder will pay a single capital gain tax on the sale of corporate property during a 12-month liquidation period and use the installment sales reporting method to report the capital gain as the corporation collects the proceeds.[34]

For the generous shareholder, ownership in a Subchapter S corporation increases the total deductible contributions he can make since the possible 5 percent of income contribution by the corporation is not included in determining the shareholder's maximum deductible contributions. Another advantage to an older shareholder-employee is that earnings of an electing corporation are considered dividends, thus they are not included in Social Security limitations based on earned income.

The availability of the Subchapter S election helps to remove tax considerations as a factor when choosing the legal form of business. The Subchapter S status allows the use of the corporate form of business without having the tax disadvantage of having the income taxed to the corporation and, upon distribution, to the shareholder.

Since the tax advantage is quickly diminished when the applicable individual tax rates exceed the corporate tax rate, the Subchapter S election is preferable when a venture is expected to operate at a loss, or if it is to be short lived, since it can avoid the collapsible corporation rules, use a 12-month liquidation plan, and report on the installment reporting basis. Once the corporation starts showing sizeable profits, the election should be revoked so the corporation may be taxed under the now more preferable corporate rates.

The use of the Subchapter S status should increase in the future due to changes made by the Economic Recovery Act of 1981. The increase allowing up to 25 shareholders will make more corporations eligible and increase financing opportunities. The lowering of individual tax rates will make such status preferable to maintain for a longer period.

The complexity of its regulations makes the Subchapter S status hard to understand. This lack of understanding leads many eligible corporations to shy away from an election. With the proper financial and legal advice, a Subchapter S status can be very beneficial to a corporation in the proper circumstances.

NOTES

[1] Ray M. Sommerfeld, Hershel M. Anderson, Horace R. Brock, An Introduction to Taxation (Chicago: Harcourt Brace Jovanovich, Inc., 1981), p. 4-6.

[2] William L. Raby, The Income Tax and Business Decisions (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1978), p. 78.

[3] Internal Revenue Code, Sec. 1371(a), (d).

[4] Ibid., Sec. 1371(a).

[5] Ibid., Sec. 1371 (a), (e).

[6] Ibid., Sec. 1371(g).

[7] Ibid., Sec. 1371(e).

[8] Ibid.

[9] Ibid., Sec. 1371(a).

[10] Ibid.

[11] Ibid., Sec. 1372(e)(5).

[12] Ibid., Sec. 1372(e)(4).

[13] D. Larry Crumbley and P. Michael Davis, Organizing, Operating & Terminating Subchapter S Corporations (Tucson: Lawyers and Judges Publishing Co., 1975), p. 28.

[14] Internal Revenue Code, Sec. 1372(b), (c), (d).

[15] Prentice-Hall, Federal Tax Course (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1981), p. 3137.

[16] Internal Revenue Code, Sec. 1372(e)(1).

[17] Ibid., Sec. 1372(e)(2).

[18] Ibid., Sec. 1372(e)(3).

[19] Ibid., Sec. 1372(f).

[20] Prentice-Hall, p. 3138.

[21] Internal Revenue Code, Sec. 1373.

[22] Ibid., Sec. 1375(d),(f).

[23]Ibid., Sec. 1375(d).

[24]Ibid., Sec. 1375.

[25]Ibid., Sec. 1375(a).

[26]Ibid., Sec. 1378.

[27]Ibid.

[28]Ibid., Sec. 1374.

[29]Crumbley, p. 287.

[30]Internal Revenue Code, Sec. 1376(a),(b).

[31]Ibid., Sec. 1376(b).

[32]Ibid., Sec. 1379.

[33]Institute for Business Planning, Successful Techniques that Multiply Profits and Personal Payoff in the Closely-Held Corporation (Englewood Cliffs, New Jersey: Institute for Business Planning, Inc., 1977), p. 11.

[34]Ibid.

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