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Tax Considerations in Organizing a Corporation

*Marvin D. Kelner**

THE 16TH AMENDMENT to the Federal Constitution in 1913, empowered Congress to levy income taxes nationally. From this authorization there has evolved the enormously complex Internal Revenue Code of 1954. This code, in turn, has had vast effect on the use of corporate form for the organization of business enterprises.

It is almost impossible, and certainly impractical, to prepare a definitive checklist of incorporation procedures, which will guarantee complete safeguard for all of the "watchdog sections" of the present Internal Revenue Code and further guarantee the lowest tax burden for the corporation and its stockholders. The most that any careful lawyer can do is to apply known and foreseeable procedures, which have been tried and tested in the courts, to any particular company he is engaged in incorporating.

It should be noted that when we consider the income tax impact on the corporation, we are also affecting the income tax burden on the stockholders. As a result, the most effective tax setup will produce the lowest burden *between* the corporation and its stockholders *at the right time*. We must consider, then, the income tax effects on the corporation and its shareholders during the life of the corporation, and also at the time of liquidation.

Preliminary Discussions

At the time of incorporation, there are several ways of providing for minimum tax burden on the corporation. One of the most successful methods is to provide for debt financing of the corporation, as opposed to equity financing. This will provide a deduction for the corporation by way of interest, as opposed to payment of a non-deductible dividend.

* B.B.A., Ohio State University; years of experience as a practicing accountant and tax specialist; and a third year student at Cleveland-Marshall Law School.

[*Editor's Note:* This article should not be taken to represent the official views or policies of the Internal Revenue Service or the United States Treasury Department. This paper represents the distillation of present opinion on tax aspects of corporate organization. It is a tax article for corporation lawyers, not a corporation article for tax lawyers.]

Another method is to provide for payment to stockholders for rental of property to the corporation. This will permit a deduction for rent on the part of the corporation.

The above two methods are the ones by far most commonly used to provide for a reduction of taxes for the corporation. Of course, the Internal Revenue Service is forever watching for these tax saving devices. They therefore can be used only after careful consideration and under tried and accepted methods.

The general tax bite (that is, on the entire business) can sometimes be reduced through use of multiple entities. For example, it is possible to have two or more corporations, or a corporation and a separate partnership composed of stockholders, to operate the proposed business. In this manner, we can split the tax burden by equalizing the tax rates between the various entities. It is always better to do this at the time of incorporation, as it is less likely to be attacked by the IRS than would be a split-up or split-off of an existing business.

When we incorporate an existing business, we have one major problem which can be solved in alternative ways. This problem is:

Should we effect a tax free exchange between the proprietorship or partnership and the corporation?

Effects

1. If taxfree, the basis for depreciation of the assets transferred into the hands of the transferee-corporation is the same as if it remained in the hands of the transferor-partnership (or proprietorship).
2. If taxable, the basis for depreciation of the assets transferred into the hands of the transferee-corporation is its fair market value.
3. If the gain or loss is recognized at the time of transfer, it is a capital gain or loss, which may be used as an offset on the individual transferor's return; that is, gain on the transfer offset against personal capital losses or loss on the transfer offset against personal capital gains.

The above summary outlines the major tax considerations in the organization of the corporation. They will be discussed in detail below.

Corporation Debt v. Equity Financing

This method of prearranging the corporate balance sheet calls for skilled interpretation of the leading court cases on the

subject. There are so many varied court decisions on so many different points of tax law, in this field, that we shall here discuss only the maxims applicable to corporate organization. Many law review articles on the case law are available elsewhere.

One major tag which has been given to this method of incorporation is "thin corporation" or sometimes "thin incorporation." Let's look at the reason for this tag.

"Thin corporation" means the substitution of debt financing (notes, bonds, debentures, etc.) in the place of some capital stock (risk capital). That is to say that, if it is determined that it will be necessary to put in \$400,000 of cash or property to insure the successful start of the corporation, shall the entire amount be set up as stock or \$200,000 as stock and \$200,000 as notes, or \$50,000 as stock and \$350,000 as notes, or etc.

There are three distinct advantages in having debt financing by stockholders.

1. The payment of interest on the debts is a payment to stockholders for which the corporation is entitled to claim a deduction from net income. If the debt were stock instead of debt, then the payment of a dividend to stockholders would not be a deductible item and therefore the corporation would pay an irretrievable part of its profits as taxes.

One minor feature of this, which should be noted, is that the payment is taxable to the stockholders, whether it be a dividend or interest. However, the receipt of a dividend by the stockholder allows for a dividend exclusion of \$50 and a dividends received credit of 4% of the amount of dividends received (from a domestic corporation). Since the tax rate of the corporation is either 30% or 52%, the saving to the stockholders is very slight in comparison to the saving on the part of the corporation. The receipt of interest by the stockholder has no special advantage under the present tax law.

2. The second advantage of debt financing belongs to the stockholder-creditor. If the company were to fail, then the loss evidenced by worthless stock is a capital loss, and thus is subject to the capital loss limitations or a maximum deduction from adjusted gross income of \$1000 (considering no other capital gains or losses on the stockholder's return).

If the company fails, then the loss evidenced by a note (that is, a loan to the corporation) may be treated in one of two ways. If it is considered a non-business bad debt (usually by an investor) then the loss is considered a short term capital loss and is treated the same as in the paragraph above, i.e., limited to a \$1000 deduction from

adjusted gross income on the creditor's return. However, if it can be shown that the loss was incurred in the stockholder-creditor's "trade or business," then the loss is deductible in full. An example of this latter situation is one where a taxpayer may own stock in four or five corporations, may also be a creditor of several or all of them, and further be a creditor of still other corporations; then it *may* be said that *loaning* money is his trade or business. There are many, many court cases on this particular issue, and if the taxpayer concerned is the type of investor-businessman with his finger in several pies, this feature of debt financing should be strongly considered.

3. The third advantage, which is sometimes overlooked, is also an advantage to the stockholder-creditor. Suppose that the financing of the corporation is set up so that 50% of the stockholder's initial holdings are stock and 50% are loans. Suppose, further, that the loans are serialized debentures payable in 5 to 10 years. The payment of the principal by the corporation is the *recovery of capital* to the creditor and, of course, nontaxable. Therefore, while the original investment was necessary for the formation of the company, the return of that investment payable out of the future earnings of the corporation is in essence a dividend which is nontaxable to the shareholder-creditor!

Needless to say, this has been attacked by the IRS many times and the outcome is always determined by the guidelines which determine the deductibility of interest on the principal. Therefore, the problems of debt v. equity financing resolve themselves to three basic alternatives:

1. Interest v. dividends
2. Non-business bad debts v. business bad debts
3. Loan repayments v. dividends.

Determining Factors

There are two basic factors which seem to have evolved from the courts' interpretations of this issue. The first is the ratio of stock to debt. The second is the type of indebtedness of the corporation.

1. The ratio of debt to stock is interpreted by the following formula: *debt:stock* (i.e., proportion of debt to stock). If the capital stock is set up as \$50,000.00, and the stockholders debt is \$450,000.00, then the ratio is 9 to 1. One would assume correctly that the higher the ratio of debt to stock, the more likely is the probability that the debt will be considered equity financing and that the deduc-

tion for interest expense will be disallowed by the IRS. What is a safe proportion? There has been no formula prescribed by the courts which would govern in all cases. Obviously, proportions exceeding 10 or more to 1 are very likely to be termed equity capital per se, whereas lesser proportions will require an exceedingly good story if they are to stand up under the courts' practised eye.

Naturally, there are various arguments which have been offered for high ratios, among which are instability of the particular business field of the corporation, instability of the managers (other than stockholders) of the corporation; type of business enterprise, etc. It is not the purpose here to argue for or against any method of setting up the capital structure of the corporation. Any argument can be turned against the stockholder-creditor, for that matter. In fact, some might argue that the less stable the corporation, the more likely that the initial investments are risk, i.e. equity, capital. Others might argue that the instability of the corporation demands for the initial investment as much protection as possible. Hence the setting up as notes rather than stock, so that the shareholders may share in the assets, in case of failure, along with the other creditors of the corporation. In the end, the courts will make the final determination of which argument is better, and the less ridiculous the proportion of debt to stock, the better the chances of the court siding with the stockholders. As a general rule, which is most certainly true in this aspect of corporate taxation as well as in all other aspects of taxation: The more bonafide business reason, other than taxes, for the issue under consideration, the more likely the courts will be to favor the taxpayer.

2. The *type* of indebtedness parallels the ratio of debt to stock, in its importance in determining the successful tax arrangement of the capital structure of the corporation. Certainly, the debt should be evidenced by a written instrument. The instrument should contain a fixed date of maturity; and it should provide for a *fixed* rate of interest *irrespective of the profits of the corporation*. The notes or other evidences of indebtedness should not be subordinated to the least preferred class of creditors of the corporation. Voting rights attached to the instrument may tend strongly to determine its character as stock rather than debt.

The *name* attached to the evidence of indebtedness is not controlling. Whether they be called notes, bonds, debentures, or any other name does not control the character of the instruments. The intent of the parties, the treatment accorded the instrument on the books of

the corporation, the treatment of the instrument with regard to subsequent, and corollary affairs of the corporation, all dovetail together to determine the true nature of the relation between the stockholder-creditor and the corporation.

In conclusion, as to this aspect of incorporation, it may well be said that, where there are good business reasons for issuing debt securities; where the equity investment is substantial and not out of proportion to the debt structure; and where the character of the instrument is conclusive as to the debtor-creditor relation between the corporation and the stockholder—then the probability is high that the debt will maintain its character as such under the scrutiny of the Internal Revenue Service.

Corporation Rental of Stockholders' Property

There have been various attempts on the part of some shareholders to retain certain property in their own name at the time of incorporation. The property retained has ranged from the usually conservative holding of real estate to the most ridiculous attempt to retain title to the machinery and equipment used in a manufacturing plant. In the latter case, the payments for rental were geared to production, thus insuring a balanced income between the stockholder partnership-lessor and the corporation-lessee.

The most general practice in this area of taxation is for the stockholders to retain the real estate upon which the physical plant of the corporation is located. Tax-wise, the corporation will have a deduction for rental expense and the stockholders will realize rental income. In many cases, where the physical plant is sizeable, this arrangement will insure a generous immediate return on the shareholder's investment.

When this kind of arrangement is set up between the corporation and its shareholders, the most common failing occurs when the shareholders charge rental from the corporation *in excess of a reasonable rental value*. The excess amount, if discovered by the Internal Revenue Service, will be considered as a payment essentially equivalent to a dividend, and disallowed as a deduction by the corporation. This happens very often where the lessee-corporation is controlled by the lessor-stockholders (as in a close corporation).

The type of property rented to the corporation must be of a strictly business nature, and should not be such as should right-

fully *belong* to the corporation. For example, one taxpayer received rental payments from the corporation for the use of his yacht. He claimed that the yacht was used solely for business entertainment. Examination of the log of the ship, by an Internal Revenue Agent, disclosed that more than 75% of the use of the yacht was by the taxpayer and his family and personal friends. Naturally, 75% of the rental payments were disallowed to the corporation, and treated as a dividend to the taxpayer-shareholder.

In another case, a corporation in the construction business rented all of its heavy equipment, including such items as bulldozers, cranes, earthformers, etc., from its sole shareholder. The equipment represented substantially all of the equipment used by the corporation in its business. The Internal Revenue Service disallowed all of the rental payments to the shareholder and allowed the corporation to deduct depreciation, interest payments and the like. Thus the excess or what actually represented net rental income to the shareholder was considered as a dividend to the shareholder, and disallowed as a deduction to the corporation. This was claimed by the IRS under Section 45 of the IRC 1939 (Sec. 482, IRC 1954) which gives the Commissioner of Internal Revenue the power to allocate or apportion income, deductions, credits, etc. in order to arrive at the true net income of related businesses. There were, of course, other factors in this case, such as the fact that the shareholder did not rent the equipment to anyone else; that he was the principal officer of the corporation and devoted all of his time to the corporation, and that some of the equipment was purchased by the shareholder with loans from the corporation to use as downpayments. This was clearly a case where the equipment rented was the corporation's property, and was properly taxed as such by the Internal Revenue Service. Note that in effect the government did not claim that the rental paid was *excessive*, but claimed rather that it did not clearly reflect the net income of the corporation.

Summarizing this area of tax consideration at the time of incorporation, it can be stated that it is possible for shareholders of a corporation to retain certain property in their own names, and to rent it to the corporation. Use of this method will enable the shareholder to report rental income which would otherwise be taxed to the corporation. This procedure is most readily adaptable to real estate assets, but also can be used with other property, especially if the shareholder rents to more than one corporation.

Excessive rental payments will almost always be disallowed as an expense of the corporation and charged as a dividend to the shareholder. If the property rented is not business property, or if it is inseparable from the business activity of the corporation, it is probable that the rental expense will not be allowed at all to the corporation.

Multiple Entities

General Discussion

Most essential to this phase of taxation is the understanding that both individual income tax rates *and* corporate income tax rates are progressive. That is, the higher the income of the taxpayer, the larger the proportionate share of tax he will pay. In a corporation, the rates now are 30% on all net income (normal tax) and 22% (surtax) on all net income over \$25,000. Thus, on \$25,000 net income, a corporation would pay a normal tax of \$7,500, and on \$50,000 net income it would pay a normal tax of \$15,000 (30% x \$50,000) and a surtax of \$5,500 (22% of \$25,000), or a total tax of \$20,500. In order to avoid this surtax, there have been hundreds of different schemes attempted in order to achieve more than one taxable entity. It is apparent that if you have two corporations earning \$25,000 each, as opposed to one corporation earning \$50,000, you will have a saving of \$5,500. If it were possible to divide your business into ten corporations, each having a net income of \$25,000 (combined net income of \$250,000), you would save \$49,500, about 20% of your combined net income.

Other than forming more than one corporation, it is possible to have the shareholders and/or their families join into a family partnership to engage in some phase of the corporation's business activity. By doing this, you divert part of the corporate earnings into the hands of the shareholders, so that not only is the income not taxed twice, but a lesser amount of tax is paid, by virtue of the fact that the shareholders are not in a high tax bracket.

It is not necessary for our purpose to become too involved with actual figures, as long as the principles of (1) avoiding double taxation, and (2) equalizing the tax brackets, are realized by the reader. Naturally, if the shareholders are in a much higher bracket than the corporation, the only avenue available in this area is multiple incorporation, thereby saving the 22% surtax rate on the net income in excess of \$25,000.

It would be of no profit to dwell here on the pros and cons of family partnerships as a tax-saving device. Without the use

of a corporation, or intertwined with corporate affairs, as they are referred to here, they present a formidable and complex means of saving income taxes, and could only be properly discussed in long and involved exposition.

Determining Factors

Standing squarely in the path of wholesale multiplication of taxable entities is Section 482 of the Internal Revenue Code of 1954, which was mentioned briefly in the previous discussion. Section 482, to restate it briefly, says that the Commissioner is authorized to distribute, apportion or allocate gross income, deductions, credits or allowances between related organizations, trades or businesses owned or controlled directly or indirectly by the same interests, if he determines that it is necessary to do so in order to prevent evasion of taxes, or to clearly reflect the income of any of such organizations, trades or businesses. This section has been called the "silent policeman" of the Internal Revenue Code.

The primary purpose of this section is to see through transactions between related businesses which are not conducted at arms length because of the controlled ownership. It does not authorize the Commissioner of Internal Revenue to consolidate net incomes of more than one business, but it has been used by the Commissioner to do just that very thing. When it is used by the Commissioner to consolidate net incomes of more than one corporation, it effectively defeats the 22% surtax saving on multiple corporations, and also defeats the avoidance of double taxations by stockholders-partnerships or proprietorships. It has not been much used by the Internal Revenue Service, but this is no assurance that it will not be used in any given case.

To illustrate the application of the multiple entity device, let us assume a corporation with branch stores in 6 states. The interests behind this business desire to incorporate each branch store within its respective state of domicile, for a number of good business reasons:

1. To overcome prejudice against absentee ownership,
2. To minimize tort and other legal liabilities against the entire operation,
3. To provide a more rigid accounting and financial control setup,
4. To provide an atmosphere of competition between the various store managers.

Thus, by incorporating in each state or for each store separately, the owners satisfy the bonafide business reasons outlined above. It is almost certain that the multiple entity device will stand up against attack by the Internal Revenue Service, for the very good reason that no one can say that saving taxes was the primary motive behind the split-up.

Another illustration will point out the application of Section 482 in effecting a consolidation of multiple entities. The owners of a certain business were engaged in selling industrial machinery. They arranged their business so that three corporations and one individual proprietorship made all of the sales. The various companies operated out of one office. Income and expenses were shifted on the books, so that each company incurred the lowest tax burden. There were no bonafide business reasons for having more than one company. The Internal Revenue Service consolidated the entire operation for tax purposes, and was upheld in so doing by the Supreme Court.

In approaching the question of multiple entities it appears logical to view the operation in the following manner:

1. Is this a business which can be separated vertically, that is, from a raw materials operation, to manufacturing or processing, to sales?
2. Is this a business which can be separated horizontally, that is, between more than one manufacturing plant or more than one sales branch?

Arguments for separating one business into a managerial corporation, a purchasing corporation, a manufacturing corporation, a designing corporation, a sales corporation, etc., seem to be very weak, because so many businesses have all these functions combined into one corporation. However, where any segment of a business may serve more than one organization, that is, more than one group of owners, the reasons for separation seem more logical and clearer. But always, each case depends on its particular facts.

On the other hand, horizontal separation for bonafide business reasons is a logical and strong argument for the multiple entity system. But in any case, no pattern or procedure can be utilized which will guarantee absolute freedom from attack by the IRS. Generally speaking, there seems to be a vague pattern of do's and don't's which have evolved from leading court decisions and which may serve to organize the subject.

1. In the first place, there had better be several important bonafide business reasons for having more than one taxable entity. While this point may seem repetitious, it would be well to remember that the Commissioner *and* the Court will both seek to know the actual intent of the taxpayer. Remember that cases involving the validity of multiple entities do not usually involve questions of facts as such; rather, the IRS will try to prove the absence of facts which serve to corroborate the taxpayer's alleged bonafide business reasons.
2. The division of one business enterprise into more than one entity can be successfully upheld if the division is logical. This means that if the sales department is divorced from manufacturing, if manufacturing is divorced from the control of real estate, etc., the IRS will be hard put to argue that the divided entities are inseparable by nature.
3. There must be absolute entity separation between the entities, i.e. separate bank accounts, separate books and records, and as much separation between officers and personnel as is reasonable under the circumstances.
4. By all means, preserve the corporate existence to the utmost degree. That is, be sure that all legal procedures are faithfully carried out and neither neglected nor intermixed with the legal papers and documents of the related companies.
5. One feature of multiple corporations which has served to thwart many attempts at multiplicity is the temptation of the owners of the business to mingle the funds of the related companies through loans, exchange checks and the like. Not only will this raise the eyebrows of an examining agent, but it will surely rock the foundation of independence upon which the corporations rest their existence. In the spirit of advice, it should be spelled out herein that this is a measure which should be used only in the last throes of corporate desperation.

Concluding this area of tax consideration, it should be emphasized that no attempt has been made here to exhaust this subject. The endless variations of tax avoidance through multiple entities suggest the vast number of cases which it would be necessary to consider in order to even attempt a narrow presentation of the subject. Furthermore, no attempt was made to discuss the ramifications of a split-up of an existing business into multiple entities, as this subject is governed by several important sections of the Internal Revenue Code of 1954.

We have attempted solely to inform a segment of the bar, whose principal work does not concern taxes, of the scope of this area of tax consideration, and to present for their general enlightenment several of the highlights of the subject to guide them on the path to further research.

Incorporating an Existing Business

General Discussion

The tax problems of incorporating an existing business manifest themselves on the exchange of the capital stock of the new corporation for property of the old business *which has appreciated or depreciated in value* with respect to its basis in the hands of the transferor. No special other problems appear to present themselves, taxwise, in this incorporation situation, and so the subject will be limited to the facts mentioned in the preceding sentence.

Section 351 of the IRC 1954 states briefly that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in a corporation, and if, immediately after the exchange, such person or persons are in control of the corporation. Control is defined as 80% ownership of each class of stock in the corporation, voting and nonvoting. (Sec. 368 (c))

In ordinary circumstances, the exchange of property which has appreciated in value, for common stock of any corporation, gives rise to a capital gain. Application of Code Section 351 will defer the recognition of this gain, in those situations where the transferors of the property simultaneously receive control of the corporation. The code provision is almost always applicable to a new incorporation of an existing business, and inasmuch as this paper deals only with tax considerations at the time of incorporation, the transfer of property to an existing corporation will not be discussed.

Under Section 112 (b) (5) of the IRC 1939, it formerly was necessary, in situations involving two or more persons, for each to receive the same proportion of stock in the new corporation as was held in the property transferred. Section 351 of the new code does not require this, and has thereby eliminated much of the controversy under Section 112 (b) (5) of the 1939 code.

Ramifications

There are three principal questions which serve to spotlight the ramifications of Code Section 351.

- A. What are the working capital requirements of the new corporation?
- B. How much, if any, are the already recognized gains and losses on the personal income tax returns of the transferors in the year of exchange?
- C. What basis for depreciation is most desirable in the hands of the transferee-corporation?

Mitigating the importance of these three questions in any given case is the necessity for the present owners to acquire 80% or more control of the corporation. If the owner or owners of the existing business demand 80% or more control of the corporation, there is no question that the transaction will be nontaxable when effected. Stock possessed by relatives, related corporations, partners, and certain other holders, is considered to be possessed by the taxpayer-transferor in accordance with Section 267(c) of the Internal Revenue Code of 1954.

To illustrate the three questions, let us assume one basic set of facts: Mr. Smith is the owner of an existing business which holds property with a basis to Mr. Smith of \$40,000 and a fair market value of \$100,000. Mr. Smith has \$25,000 of cash of his own with which to incorporate.

- A. If Mr. Smith effects a nontaxable incorporation, then he will retain his \$25,000 cash for working capital in the new corporation. If he effects a taxable incorporation, then he will incur a capital gains tax of approximately \$15,000; thus reducing his working capital to \$10,000. The problem here resolves itself to simple arithmetic, and the tax burden may or may not be welcome, depending upon the considerations involved in questions B and C, as well as working capital requirements.
- B. Assuming the same facts, suppose that Mr. Smith had other capital losses on his personal return, which could be used as an offset against the gain recognized on the exchange. In such a case it might be well to recognize the gain by effecting a taxable transaction. Otherwise the benefit of the loss might be limited to \$1000 deduction from adjusted gross income, as is true in a situation where capital losses exceed capital gains. On the other hand, assume that the property had a basis to Mr. Smith of \$100,000, and a fair market value of \$40,000. In a taxable transaction the \$60,000 loss may be used to offset other capital gains on Mr. Smith's personal return.

- C. One of the important concepts of Section 351 is the principle that the basis of the property transferred to the corporation in a nontaxable transaction is the same as it was in the hands of the transferor. Therefore, in a nontaxable exchange, the basis of the property transferred in Mr. Smith's case would be \$40,000, and the corporation will assume this basis for depreciation. If the exchange were taxable, then the basis of the property in the hands of the corporation would be \$100,000, and the corporation would be able to depreciate the property on this basis.

Conclusion

In concluding this area of tax consideration, it should be stated that the three questions of (1) working capital requirements, (2) personal capital gains and losses, and (3) corporation basis for depreciation must be weighed together and individually, in order to arrive at the proper decision in any given case. Against the ramification of the three major questions looms the problem of control. Schemes to thwart Section 351 by issuing 21% of the common stock to a friend, with the agreement to immediately repurchase, will probably be looked upon as one transaction, and 80% control will be determined to have been obtained at the time of the original exchange.

As readily can be seen, then, the incorporation of an existing business must be carefully considered from the standpoint of Section 351 of the IRC 1954, and each factor must be weighed with care before the transaction. Once the exchange is effected, the transaction is irrevocably committed to the operation of the applicable section of the Code.

As a final point, it is emphasized that the tax laws of the particular state, as well as those of the federal government, should be consulted.*

* See, for example, as to particular states, Oleck on New York Corporations, c. 70, et passim (1954); Townsend's Ohio Corporation Law, 10 (3rd ed., 1956).