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Subchapter S Corporations and the One Class of Stock Requirement: Should Debt Ever Be Reclassified As A Disqualifying Second Class of Stock?

Under the rules of Subchapter C, of the Internal Revenue Code of 1954, which govern the taxation of most corporations, numerous tax benefits attach to the use of shareholder held debt rather than equity.1 These advantages have encouraged shareholders to make their contributions to the risk capital of the business in the form of loans. In order to forestall such tax avoidance schemes, the Commissioner of Internal Revenue and the courts have frequently chosen to reclassify as equity those shareholder contributions which do not represent bona fide debt.2 Fewer tax benefits accrue from the use of shareholder debt under the Subchapter S provisions of the Code,3 which provide an alternative method of taxation for certain eligible small business corporations. Nevertheless, the Commissioner has applied the doctrine of debt reclassification in this sphere with vengeance, employing the doctrine to create a second class of stock which revokes the offending corporation’s Subchapter S election. This Note will examine the proper function of debt reclassification under Subchapter S.

I. Taxation of Subchapter S Corporations in General

Under sections 1371 through 1378 of the Internal Revenue Code, certain “small business corporations”4 may elect to avoid taxation at the corporate level,5 provided that the corporate income and loss are reported by the individual shareholders in relation to their proportionate stock ownership.6 To be eligible for such treatment, a corporation must meet certain qualifications. It must be a domestic corporation7 which is not a member of an affiliated group8 and which has no more than ten shareholders,9 all of whom

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1 The corporate and shareholder advantages and disadvantages of debt financing have been considered in Caplin, The Calorie Count of a Thin Incorporation, 43 Marq. L. Rev. 31 (1959); Schlesinger, “Thin” Incorporations: Income Tax Advantages and Pitfalls, 61 Harv. L. Rev. 50 (1947).
2 For an exhaustive list of cases concerning the various facets of the doctrine of debt reclassification, see M. Lore, Thin Capitalization, 33-162 (1958); Caplin, supra note 1.
4 Int. Rev. Code of 1954, § 1371(a). Although section 1371 denominates an eligible corporation as a “small business corporation,” there is no limitation upon the amount of the capital of the qualifying company.
6 Although the general outlines may be similar, the taxable status of a Subchapter S corporation differs greatly from that accorded to partnerships. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 711 (2d ed. 1966); Caplin, Subchapter S vs. Partnership: A Proposed Legislative Program, 46 Va. L. Rev. 61 (1960).
8 Id. The term “affiliated group” is defined in Int. Rev. Code of 1954, § 1504.
must be individuals or estates and none of whom may be a nonresident alien. The corporation may not derive more than eighty per cent of its gross income from foreign sources and no more than twenty per cent of its gross income may be passive investment income. All shareholders must consent to the election, either before the end of the first month of the first taxable year or within thirty days of the date on which they become shareholders. Finally, the corporation must not have more than one class of stock.

The general principle governing taxation under Subchapter S is that operating gains and losses are "passed through" the corporation and taxed directly to the shareholders on a pro rata basis according to their stockholdings. Specifically, each shareholder must include in his gross income the amount of current earnings and profits that are actually distributed to him. This amount constitutes an actual dividend. Since there is no taxation on the income at the corporate level under Subchapter S, a major concern is the taxation of that corporate income which is not actually distributed to the shareholders. Thus each shareholder must include in his gross income his share of the corporation's undistributed taxable income (UTI) which would have been a dividend if it had been distributed on the last day of the corporation's taxable year. This amount constitutes

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15 Int. Rev. Code of 1954, § 1372(e). The election must be made during the first month of the year to which it applies or during the preceding month. Int. Rev. Code of 1954, § 1372(e)(1); Treas. Reg. § 1.1372-2(b) (1959). Once the election has been made, however, it continues in effect for all succeeding years unless some subsequent event terminates the election. Int. Rev. Code of 1954, §§ 1372(d), (e). This termination may be either intentional or inadvertent. The corporation may not re-elect after such an event without the Commissioner's consent until five years have elapsed. Int. Rev. Code of 1954, § 1372(f).
17 The taxable income of a Subchapter S corporation is computed in the normal manner, except that no deductions are allowed for net operating losses under section 172 or for any other of the special corporate deductions listed in sections 241-47. See Int. Rev. Code of 1954, § 1373(d).
18 Int. Rev. Code of 1954, §§ 1373(b), 1374(c). When passed through to the shareholder, taxable income, with one exception, does not retain the characteristics it possessed in the hands of the corporation. See Int. Rev. Code of 1954, § 1373(b). The one exception is that, under section 1375(a), the excess of the corporation's net long-term capital gain over its short-term capital loss is passed through as such to the shareholders. But cf. Int. Rev. Code of 1954, § 1378.
19 The distribution must qualify as a dividend under section 316 before the shareholder will be taxed at ordinary rates. If there were no earnings and profits from which the distribution could be made, the distribution will be covered by the provisions of section 301.
a constructive dividend. The amount of the UTI which has been taxed to
the shareholder is credited to his account as previously taxed income
(PTI), and the basis of his stock is increased by that amount. For exam-
ple, if shareholder A owns one-third of the outstanding stock of Corpora-
tion X at the end of the taxable year and Corporation X has $30,000 of UTI
for that year, then A must include $10,000 income on his individual return
as his share of the UTI. A’s basis in the stock is thereby increased by
$10,000. The same results would be achieved if the corporation had paid
A an actual dividend of $10,000 and A immediately reinvested that amount
in the corporation as a contribution to capital. Thus the amount is deemed
constructively distributed and reinvested as a capital contribution.

Since the shareholder has already been taxed on the undistributed in-
come in his PTI account, he is permitted to receive that amount from this
account without the payment of further taxes. Money distributions dur-
ing the first two and one-half months of the taxable year are deemed to
reduce UTI of the previous taxable year. All amounts distributed after
the first two and one-half months are first allocated to current earnings and
profits. Thus these distributions must first exceed current earnings and
profits before the PTI account can be reduced. Since the shareholder’s
basis in his stock was increased by amounts credited to his PTI account,
any PTI distribution will correspondingly reduce the basis at which the
stock is held.

For tax purposes, perhaps the most significant difference between Sub-
tion’s taxable income is calculated in the same manner as for Subchapter C corporations
except that no net operating loss deductions are carried over. Int. Rev. Code of 1954,
§ 1373(d); see Rev. Rul. 70-396, 1970-1 Cum. Bull. 179. UTI is determined by subtracting
from taxable income the amount of actual dividends distributed in cash. Distributions in kind
do not reduce UTI, but they may reduce earnings and profits. See Treas. Reg. § 1.1373-1(e)
(1959) which provides that earnings and profits are first allocated to actual dividends paid
in cash with any excess being allocated ratably to UTI and actual dividends paid in property
other than money.

21 Int. Rev. Code of 1954, § 1375(d). Each individual shareholder has his own personal PTI
account representing prior taxable corporate income which he has reported in his own individual
return and on which he has paid the appropriate tax. This PTI account is personal to the
original shareholder. It is not an account attributable to the shares of stock themselves and
thus it cannot be transferred even though the stock is subsequently transferred. Any later
distribution to the original shareholder out of his PTI account will not be taxable to that
shareholder. Id.


L. Rev. 185, 188 (1959).


25 Int. Rev. Code of 1954, § 1375(f). Such distributions are not considered as dividends,
and the earnings and profits of the corporation are not reduced by reason of such distribu-
tions. Id.


27 See note 22 and accompanying text supra.
chapter C and Subchapter S corporations is the treatment of net operating losses. In the Subchapter C context there is no direct effect on the shareholder's income when the corporation suffers losses.\textsuperscript{23} In Subchapter S corporations, however, the corporation's net operating loss is "passed through" directly to the individual shareholders as an ordinary loss.\textsuperscript{24} The shareholder's portion of the loss is determined on a pro rata basis attributable on that pro rata basis to the shares held by him on each day of the taxable year.\textsuperscript{25} For example, if the shareholder owned ten per cent of the corporation's stock for six months of the taxable year, his portion of the net operating loss would be five per cent.\textsuperscript{26} The taxpayer, then, may utilize this loss deduction to offset any income he may have had from outside sources. The taxpayer may carry the loss back and forward to other tax years.\textsuperscript{27}

The shareholder's use of this net operating loss deduction does, however, have one important limitation. A shareholder may not deduct an amount in excess of the basis in his stock plus the basis in any indebtedness which the corporation may owe to the shareholder.\textsuperscript{28} Thus, if a shareholder's portion of the net operating loss amounts to $50,000, but his adjusted basis in stock and indebtedness\textsuperscript{29} is only $25,000, the excess $25,000 may not be deducted. The excess loss may not be carried over to a subsequent year nor back to a prior year, and thus the use of that loss may be lost to him forever.\textsuperscript{30}

The foregoing is an outline of the general provisions for taxation of Subchapter S corporations. The obvious major advantages of Subchapter S tax treatment are the elimination of the double-taxation aspects of corporate income distributed as dividends,\textsuperscript{31} the elimination of the threat of the penalty tax on accumulated earnings,\textsuperscript{32} the elimination of the threat of personal holding company taxes,\textsuperscript{33} and, perhaps most advantageous, the

\begin{itemize}
  \item Such losses do, of course, have an indirect effect on the shareholders in that the fair market value of their stock is probably reduced. Upon sale or liquidation, the shareholder might realize either less gain or more loss because of this reduced value.
  \item INT. REV. CODE OF 1954, §§ 1374(a), (b), (c)(1).
  \item INT. REV. CODE OF 1954, § 1374(c).
  \item This differs from the determination of an individual's share of the UTI which is based on the shareholder's stock ownership on the last day of the taxable year. See INT. REV. CODE OF 1954, § 1373(b).
  \item INT. REV. CODE OF 1954, § 1374(c)(2).
  \item The basis of any indebtedness is determined at the year's end without regard to any adjustments for that taxable year. INT. REV. CODE OF 1954, § 1374(c)(2)(B).
  \item See INT. REV. CODE OF 1954, § 1374(c)(2).
  \item Sections 301 and 316 provide that shareholders be taxed at ordinary rates on any corporate distribution which qualifies as a dividend, even though the corporation may have already paid a separate tax at the corporate rates.
  \item INT. REV. CODE OF 1954, §§ 531-37.
  \item INT. REV. CODE OF 1954, §§ 541-47.
\end{itemize}
availability of the net operating loss deduction to the shareholder.29

Subchapter S treatment may prove to be disadvantageous if the individual shareholders are in tax brackets with rates higher than the corporate rate, especially if the corporate income is left in the corporation and not distributed to the shareholders. Perhaps the most serious disadvantage of the Subchapter S election lies in the possibility of inadvertent termination of the election. The election may be terminated in any of the ways mentioned in section 1372(e). One of the bases for termination of the election is the corporation's failure to meet the definitional requirements of an electing small business corporation as set forth in section 1371(a).43 Thus the election may terminate, for example, if stock is sold or transferred to an eleventh shareholder or if the corporation ceases to have only one class of stock.41

This inherent disadvantage becomes painfully obvious when at the end of the taxable year it is determined that the Subchapter S status has been lost at some time during the year. The result is the loss of the election for the entire taxable year and instead of Subchapter S tax treatment, the corporation is taxed as a conventional corporation. Thus tax is imposed at the corporate level at the appropriate rate and all actual distributions made during the year which qualify as dividends will be taxed to the shareholders as such. Since the shareholders would have been unaware of the termination, the dividend policy of the corporation would have been based upon the assumption that there would be no such double taxation. In cases involving high profits and a large distribution of dividends, the resultant increase in tax could be disastrous. If the situation is such that the termination is not brought to the shareholder's attention for several years, the disastrous consequences naturally would be increased.

II. THE ONE CLASS OF STOCK REQUIREMENT AND DEBT RECLASSIFICATION

A. In General

The debt versus equity classification has been a major area of tax litigation in the case of conventional corporations.22 The reclassification problem arose because corporations and shareholders were using the differences between tax treatment of loans and equity contributions to avoid certain taxes. The chief advantage to the corporation is that it can deduct the interest on the indebtedness paid to the shareholder.42 Moreover, by using

29 INT. REV. CODE OF 1954, § 1374.
30 See notes 4-10 and accompanying text supra.
42 See generally B. Binder & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 4.02-.09 (3d ed. 1971).
43 INT. REV. CODE OF 1954, § 163(a). If the corporation were able to classify equity contributions as debt obligations, then payments which should actually be dividends would be considered as interest payments and hence deductible by the corporation.
debts rather than stock, the corporation can protect itself against the accumulated earnings surtax since the retention of earnings to retire legitimate debt has been deemed a reasonable business purpose.

Historically, then, the debt versus equity classification problem arose in cases of attempted tax avoidance. Thus the original body of litigation that set the rules governing reclassification had as its sole purpose the prevention of such tax avoidance. In each case, the result of the reclassification was to deny the taxpayer the improper tax benefit sought in labelling the obligation as debt rather than equity. It would therefore appear that in the case of conventional corporations it would be improper to make such a reclassification unless the taxpayer were mislabelling the form of his capital contribution in order to gain an improper tax benefit.

Reclassification in the Subchapter S context has a peculiar effect. Instead of merely denying the taxpayer the improper tax benefit, reclassification operates to deny the taxpayer the entire benefit of being taxed as a Subchapter S corporation. To terminate this benefit, proof should be required that the use of debt abuses the very scheme of Subchapter S taxation. However, to terminate the benefit pursuant to reclassification under section 1371(a)(4) (which sets forth the one class of stock requirement) a showing that the use of debt frustrates the congressional purpose behind that particular statute should be essential. Until recently, however, courts considering debt reclassification in the Subchapter S context have failed to analyze the problem in this manner.

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12 See Gazette Tel. Co., 19 T.C. 692 (1953), aff'd, 209 F.2d 926 (10th Cir. 1954).
Where, however, the debt is not bona fide, such accumulations will not be treated as part of the "reasonable needs of the business." Cf. Smoot Sand & Gravel Corp., 15 CCH Tax Ct. Mem. 418, 432 (1956), rev'd on other grounds, 241 F.2d 197 (4th Cir.), cert. denied, 354 U.S. 922 (1957).

Recaprisation has been made in situations involving the following issues:

1. Whether payments by a corporation are deductible interest payments or nondeductible dividends. Wilber Security Co., 31 T.C. 938, 948-52 (1959), aff'd, 279 F.2d 657 (9th Cir. 1960).
2. Whether payments by a corporation are deductible as the cost of goods sold or nondeductible dividends. Sherwood Memorial Garden, Inc., 42 T.C. 211 (1964).
3. Whether a corporation realizes income upon the cancellation of notes given by a corporation to a shareholder in return for money advanced to the corporation. J.A. Maurer, Inc., 30 T.C. 1273 (1958).
4. Whether shareholder advances to a corporation are to be considered bona fide indebtedness for the purposes of the bad debt deduction of section 166. American - LaFrance - Foamite Corp. v. Commissioner, 284 F.2d 723 (2d Cir. 1960).
5. Whether amounts paid by a corporation to an investor are to be treated by him as repayments of a bona fide loan or as dividends. Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956).

14 See pp. 210-13 infra.
B. The Development of Case Law

The early cases did not address themselves to the question of whether the alleged improper use of debt in any way thwarted the congressional purpose of the one class of stock requirement. Section 1371(a)(4) states only that an electing small business corporation may not "have more than one class of stock." The Treasury Department implemented this requirement through a regulation which stated in part:

If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, the corporation is considered to have more than one class of stock . . . . If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock. 49

Courts were initially concerned only with formulating the tests to be applied in determining whether debt was "actually stock" under the original regulation. Although validity of the regulation itself was not questioned, there were a few early indications that the presence of a possibility for tax avoidance might be an important consideration in the reclassification determination. 50

Despite the incentives for debt financing under Subchapter S, no challenge to such shareholder loans reached the courts until 1964. In Catalina Homes, Inc., 51 the Tax Court upheld the Commissioner's revocation of the corporation's election under Subchapter S on the ground that the extensive shareholder loans constituted a second class of stock. In this case, the corporate stock was completely controlled by two individuals. Frank Spano owned fifty-one per cent and was voting trustee of a voting trust 52 owned by other members of his family which owned fourteen per cent of the stock. George Blackshaw owned one per cent and was voting trustee of the voting trust which held the remaining thirty-four per cent. The initial capital contribution represented by the stock was $10,000. In addition, Spano loaned the corporation $45,500 on open account and Blackshaw loaned $24,500 in the same manner. 53 Furthermore, a shareholder's agreement

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50 See cases cited in Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 n.5 (1964); Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962).
52 The Commissioner also contended that the Subchapter S election should be revoked because it had as shareholders persons who were not individuals. See Int. Rev. Code of 1954, § 1371(a)(4). The court, however, in view of its determination on other issues felt it unnecessary to decide whether the voting trusts are to be considered as shareholders so as to disqualify the corporation under section 1371(a)(4). 23 CCH Tax Ct. Mem. at 1368.
53 These advances were directly proportionate to the amount of stock controlled by each—65 percent by Spano and 35 percent by Blackshaw. The court, nevertheless, placed no
between Spano and Blackshaw provided that the loans would bear five per cent interest payable at the discretion of the Board of Directors and that dividends on the common stock could not be paid until the loans had been repaid in full with interest.\textsuperscript{54}

The Commissioner argued in the Tax Court that the standard criteria developed in cases involving conventional corporations should be applied to determine whether advances by a shareholder to his corporation were true loans or whether they were in reality equity contributions.\textsuperscript{55} Although the court recognized the significance that tax avoidance motives had played in the development of these reclassification criteria,\textsuperscript{56} reclassification of the loans as equity was deemed necessary in this case because the purported loans were not evidenced by any notes and carried no maturity date,\textsuperscript{57} because the five per cent interest was payable only at the discretion of the board of directors,\textsuperscript{58} and because the loans were made soon after incorporation to supplement capital contributions which were obviously inadequate to meet the reasonable needs of the business.\textsuperscript{59}

The taxpayer argued against this reclassification on the theory that reclassification should only be ordered to eliminate any possible tax avoidance. In particular, the corporation argued that it was not seeking interest deductions in the place of nondeductible dividends since, under the applicable Subchapter S rules, the interest deductions would benefit neither the
great emphasis on this fact:

The existence of proportionality between the amount of shareholder advances and the percent of stock owned by the shareholders is merely, in some circumstances, an indication that the advances have, in fact, been placed at the risk of the business and actually constitute capital contributions. Under the circumstances before us, it is of no significance whether the advances by Spano and Blackshaw were proportionate to their stockholdings; for [the Commissioner] has called our attention to other factors indicating that their advances were placed at the risk of the business.

23 CCH Tax Ct. Mem. at 1367. See id. at 1367 n.7.

\textsuperscript{54} Id. at 1362.

\textsuperscript{55} The name given to the instrument, if any, is not conclusive but is to be considered along with the other facts. The presence or absence of a maturity date for the indebtedness, the right of the creditor to enforce the payment of principal and interest, participation in management, whether the creditor subordinates his debt to those of the other corporate creditors, whether the corporation is adequately capitalized, identity of interest between creditor and shareholder, whether the advance was made at the time of the organization of the corporation, and the ability of the corporation to obtain loans from outside sources are among the factors which, depending upon the context in which they are found, may be indicative of whether the amounts advanced have been placed at the risk of the business as capital or are genuine loans.

Id. at 1365. See generally Bravenec, The One Class of Stock Requirement of Subchapter S—A Round Peg in a Pentagonal Hole, 6 Houston L. Rev. 215, 230-31 (1968).

\textsuperscript{56} 23 CCH Tax Ct. Mem. at 1367.

\textsuperscript{57} Id. at 1365.

\textsuperscript{58} Id.

\textsuperscript{59} Id. at 1366.
corporation nor the shareholders. The court recognized that a motive to avoid taxes is a prerequisite to debt reclassification, but said that the corporation's argument failed to go far enough because there were other possible tax benefits besides the interest deduction which the taxpayer had failed to demonstrate were not motives in the loan designation. On this point, however, the court's opinion stops short in that it fails to point out a single element of tax avoidance resulting from labelling advances as debt rather than equity in the Subchapter S context. The court failed to point out any tax benefit which might be derived from the debt label—except, of course, the obvious tax benefit of retention of Subchapter S status.

Once the debt had been reclassified as equity, the court moved to the further question of whether the obligation constituted a disqualifying second class of stock. It employed the first part of Regulation 1.1371-1(g) which stated that a "difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation." Since the advances in question were preferred in that they were to be paid before any dividends on the common stock, the court, relying on the seemingly mandatory language of the regulation, concluded that the advances did constitute a disqualifying second class of stock. The election, therefore, was held invalid.

Recognizing the severe consequences resulting from this application of the regulation's automatic second class of stock rule, the Tax Court, in its 1966 decision in W. C. Gamman, rejected the regulation's rule and substituted a more flexible approach.

The taxpayers in Gammon had organized Century House, Inc. in 1959 for the purpose of constructing a motel near the site of the proposed Seattle World's Fair. Three shareholders capitalized the corporation by contributing

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Since there is no tax at the corporate level, the same amount of taxes would be paid whether the amounts paid with respect to the shareholder advances were considered interest or dividends. The shareholders of the corporation would receive these amounts and report them as ordinary income whether such amounts be considered interest or dividends. Thus the taxpayer contended that there was no element of tax avoidance in the designation of the advances as loans. Id. at 1366-67.

The court does refer to other issues in which the application of such reclassification criteria has arisen; however, it fails to point out how any of these issues have special application in the Subchapter S context. See note 46 supra.


56,339 (9th Cir. 1967).
ing $600 for no par common stock and $28,000 for six per cent demand notes. After the stock and debt securities of one of the shareholders were redeemed, the corporation during the next three years obtained $700,000 in additional financing from outside sources. The venture soon became unfavorable and the two shareholders were forced to make $250,000 in additional loans, these loans being in equal amounts and evidenced by demand notes. The shareholders had made no effort to force payment of these obligations when the corporation filed an election under Subchapter S for 1961 and 1962 in order to pass through to its shareholders the losses sustained in those years. The Commissioner, however, determined that the loans were in fact a contribution to capital and therefore a second class of stock which disqualified the corporate election and thereby disallowed the taxpayer's deduction of the losses.

The Tax Court agreed with the Commissioner that the taxpayer's advances represented contributions to capital rather than bona fide loans. The court felt that "the advances . . . were . . . placed at the risk of the business" and in that sense represented equity capital. The court emphasized not only the high debt-equity ratio of the capital structure, but also the fact that outside investors would not have loaned the corporation money on the same terms as had the shareholders. The crucial question before the court, however, was not whether the advances were debt or equity, but rather whether they constituted a second class of stock. Since the advances were made pro rata by the shareholders, the court reasoned that no change in the relative rights of the shareholders had occurred. The advances represented no more than additional contributions to capital "which were in reality reflected in the value of the common stock already held by petitioners." As such, the court held that the advances did not constitute a second class of stock even though they did represent equity.

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79 The corporation had from time to time issued new notes in exchange for the old in order to avoid the running of the statute of limitations; however, the shareholders had waived all interest payments and had made no effort to force payment. Id. at 4.
71 Id. at 5.
72 Id. at 6.
73 Id. at 9.
74 Id. at 10.
75 Id. at 9.
76 [W]e must also look to the realities of the situation to determine whether the instruments, even though they might represent equity capital, actually gave the holders thereof any rights and interests in the corporation different from that owned by the holder of the nominal stock. We do not think they did under the circumstances here present, because the advances were made and the notes were held by the shareholders in direct proportion to their stockholdings. . . . [W]hatever preferences the notes gave them in the income and assets of the corporation . . . were preferences only over themselves as stockholders.
Id.
77 Id.
contributions. That part of Regulation 1.1371-1(g) which purported to transform any disguised debt obligation into a second class of stock was held to be invalid.\(^7\)

In the aftermath of the *Gamman* decision, the last sentence of the regulation was changed to read:

Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. *However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock such purported debt obligations will be treated as contributions to capital rather than a second class of stock.*\(^7\)

The Commissioner then limited his attack to situations involving disproportionate loans. However, he failed to meet with significant success.\(^8\) For example, in *James L. Stinnett, Jr.*,\(^9\) the Tax Court stated:

> [\(\text{I}t\) is only reasonable to assume that the Congress did not intend that debt owing to a stockholder of a Subchapter S corporation would result in more than one class of stock under the thin-capitalization doctrine. This is not to say that an instrument called a "note" may not by its very terms be something else. However, where the instrument is a simple installment note, without any incidents commonly attributed to stock, it does not give rise to more than one class of stock within the meaning of section 1371 merely because the debt creates disproportionate rights among the shareholders to the assets of the corporation.\(^9\)"

Thus the court held Regulation 1.1371-1(g) invalid as applied to the facts of the case.\(^9\)

\(^7\) *Id.* at 8. Judge Drennen noted that, in limiting eligibility to those corporations with a single class of stock, Congress sought to achieve two purposes: to afford relief to businesses which were comparable to partnerships and proprietorships, and to avoid the complexities of passing corporate gains and losses through to stockholders with different rights. See S. REP. No. 830, 88th Cong., 2d Sess. 146 (1964). Nothing in this legislative intent was deemed to warrant a *per se* rule that all ostensible debt which is actually equity capital should be classified as a second class of stock. 46 T.C. at 8.

\(^8\) Treas. Reg. § 1.1371-1(g) (1966) (emphasis added).

\(^9\) The proportionality rule has been rejected in a number of cases. See, e.g., Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (6th Cir. 1972); Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972); *James L. Stinnett, Jr.*, 54 T.C. 221 (1970).

\(^9\) 54 T.C. 221 (1970).

\(^9\) *Id.* at 232.

\(^9\) *Id.* at 230. The court apparently was influenced by the fact that the transaction in question seemed to have "substance" and the fact that the classification as debt rather than equity resulted in no improper tax advantage which might "frustrate the purpose of the taxing statute." See *id.* at 232.
The Stinnett analysis of whether the classification as debt rather than equity might "frustrate the purpose of the taxing statute," is a factor which was lacking in Catalina Homes and Gamman. Catalina Homes did, however, hint at a tax avoidance consideration but expressed the view that the use of debt might frustrate the taxing statutes in general. The Gamman court also hinted at this consideration when in its conclusion it stated that although it had paid "lip-service to the thin capitalization doctrine," it doubted the doctrine's applicability in the Subchapter S context since it could not readily see any tax benefit to be gained by calling equity debt. The Stinnett court chose to base its decision on the fact that the use of debt in that case in no way frustrated the congressional purpose of the taxing statute and thus concluded that the regulation was invalid as applied to the facts of that case. The court did not, however, consider the further question of whether the thin capitalization doctrine should ever be applied to reclassify debt in a Subchapter S corporation. Presumably, if there were an improper tax advantage to be derived from failure to reclassify, then the doctrine should be applied and the regulation is proper in so far as it allows that reclassification to be made.

C. Recent Developments

In July, 1972, the Seventh Circuit handed down its decision in Portage Plastics Co. v. United States. This was the first time that the Gamman-initiated amendment to Regulation 1.1371-1(g) was applied by a court to reclassify debt as a disqualifying second class of stock. Although the decision was subsequently reversed by the court sitting en banc, an analysis of the initial decision should serve to demonstrate some of the typical errors made in analyzing the reclassification problem.

The Portage case involved equal advances by non-stockholders Elizabeth Berst and Sarah Garnett in the amount of $12,500. The debt instruments provided for repayment within five years with five per cent interest to be paid from the corporation's net profit before taxes. Either could be renewed, at the holder's option, for a second five year period and no provision was made for repayment in the event of the corporation's default on "interest" payments, nor was any sinking fund provided to assure timely retirement of the obligations. In addition, both notes were subordinated to the rights of other creditors on two separate occasions. The court emphasized the high debt to equity ratio and the fact that no distributions were

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84 Id. at 232.
85 See notes 60-62 and accompanying text supra.
46 T.C. at 12.
88 470 F.2d 308 (7th Cir. 1972), rev'd en banc, 73-1 U.S.T.C. 80,511 (7th Cir. 1973).
89 73-1 U.S.T.C. 80,511 (7th Cir. 1973).
90 470 F.2d at 310-11.
made to the common stockholders for the three year period under consider-
ation. On the basis of these facts and the overall character of the notes
themselves, the court concluded that the debt obligations were in fact eq-
uity.\footnote{Id. at 311.}

Having reached this conclusion, the court then determined that the
existence of preferential rights over the common stockholders demanded
the application of the regulation.\footnote{Id. at 312-15.} The amended regulation provided that
all reclassified debt would be considered a second class of stock unless it
was held proportionately to the holder's nominal stock interest. Since the
obligations were held by non-stockholders, the court concluded that they
were clearly held disproportionately to the holder's nominal stock inter-
est.\footnote{Id. at 315.} Thus the application of the regulation required reclassification as a
second class of stock which resulted in an invalidation of the Subchapter
S election. The majority opinion expressed the view that the regulation was
in keeping with the purpose of the statute which it interpreted as the
"elimination of administrative complexities."\footnote{Id. at 315 n.12.} These administrative com-
plexities, it reasoned, were likely to be most serious when there is some
unequal treatment of stockholders created by either preferred stock or
reclassified debt, which gives preferential rights.\footnote{Id. at 316.}

Judge Cummings' dissent in \textit{Portage} points to the failure of the majority
to delve into the underlying purpose of the one class of stock requirement.
He focused on the lack of any tax avoidance motive in the case.\footnote{Id. at 317-18 (dissenting opinion).} Had there
been any improper tax advantage in the use of debt, Cummings suggests
that the proper remedy would be to deny that particular benefit sought,
rather than to deny Subchapter S status altogether.\footnote{Id.} He reasoned that the
congressional desire in promulgating the one class of stock requirement
was the elimination of administrative problems which might arise regarding
certain payments of dividends. If the payments are classified as inter-
est by the parties involved, then that problem could never arise. There is,
therefore, no need for the Commissioner to seek to reclassify such pay-

\footnote{Id. at 311.} \footnote{Id. at 312-15.} \footnote{Id. at 315.} \footnote{Id. at 316. The court distinguished the previous cases in which the proportionality rule of Regulation 1.1371-1(g) had been applied because the purported debt owners in this case did not own any of the nominal stock. Id.} \footnote{Id. at 315 n.12.} \footnote{Id.} \footnote{Id. at 317-18 (dissenting opinion).} \footnote{Id. "To the extent that improper tax avoidance by use of the guise of debt is still possible in the Subchapter S context, the thin capitalization doctrine remains available to prevent the abuse. Where on the facts of a particular case the Commissioner shows that the taxpayer spuriously labeled an advance as debt in order to reap an improper tax benefit, then the capitalization doctrine serves its intended purpose when it is invoked to deny the particular benefit wrongfully taken . . . ." Id. at 318.}
ments as dividends rather than interest. 9

Upon reconsideration en banc, the Seventh Circuit incorporated Judge Cummings' dissent and held that the traditional thin-capitalization doctrine tests for determining whether a purported loan should be treated as an equity contribution in order to prevent improper tax avoidance in other contexts is not suitable for determining whether a purported loan constitutes a second class of stock in the Subchapter S context. 10 The decision emphasized the fact that problems involving allocation of income to stockholders of different classes will never arise so long as interest payments are treated as such. 11 And again, it emphasized the fact that if the government is concerned with "nefarious tax avoidance motive[s] in denomiating certain advances as debt," 12 it should attack those improper motives directly.

The Portage court's sentiments concerning the desirability of a "direct attack" are appropriate. The current regulation, however, is an awkward mechanism to use in guarding against debt abuses in Subchapter S corporations. The regulation directs the court to make an initial determination of whether the debt is actually equity, 13 presumably employing the traditional thin-capitalization analysis. If the court finds that the debt is equity, then it must determine whether the obligation is a second class of stock. 14 Only upon a finding of a second class of stock will termination of the election be proper. 15 Presumably, the only guidelines for determining whether debt, reclassified as equity, constitutes a second class of stock are contained in the first part of the regulation which states that varying rights and interest indicate more than one class of stock. 16

The regulation, however, makes no explicit statement regarding the abuse of debt per se. If debt abuse is the evil to be attacked, it would be more sensible, as the Portage court suggested, to attack the evil straightforwardly rather than to attack it through a cumbersome two-step process, requiring first, a finding that the purported debt is in fact equity and second, a finding that the equity is a second class of stock.

It must be borne in mind that there are other remedies besides termina-

9 Id. at 321.
10 Portage Plastics Co. v. United States, 73-1 U.S.T.C. 80,511 (7th Cir. 1973).
11 Id. at 80,514. A problem might arise, it is suggested, if income in one year is allocated on an equal basis among both common and preferred shareholders but is not at that time distributed to them. If in the following year the preferred shareholders are paid dividends in excess of current earnings, a situation might arise in which the common shareholders' ordinary gain from the prior year can only be offset by a later capital loss. For a further discussion of the problem, see p. 222 infra.
12 73-1 U.S.T.C. at 80,516 (7th Cir. 1973).
14 Id.
15 Id.
16 Id.
tion which may be employed to correct any abusive use of debt within a Subchapter S corporation. Logically, the remedy should depend on the particular abuse and the improper tax benefit sought to be derived. In some instances it would be possible to correct the abuse merely by denying the particular benefit sought. If this can be done without affecting the Subchapter S status of the corporation, there is no reason why termination should be invoked as an added penalty. In other instances, termination may be appropriate. For example, debt could be used to receive a capital contribution from an eleventh shareholder, from a corporation, an alien or some other source forbidden by the requirements of section 1371(a)(1)-(3).

Beyond these examples of blatant abuse, however, it is difficult to imagine other situations in which debt might be used in a manner which would warrant termination. Of course, if debt is used to accomplish the very result that the one class of stock requirement seeks to avoid, termination through the two-step reclassification process is entirely proper.

Thus there are three possibilities. First, debt may be used to gain an improper tax benefit. In such a case, denial of the particular benefit is the appropriate remedy. Second, debt may be used in such a way as to abuse the statutory framework of Subchapter S, in which event termination may be appropriate. Third, debt may constitute the prohibited second class of stock. Here again, termination of the Subchapter S election may be necessary. In any event, it is only this third possibility that should be covered by any regulation promulgated under the authority of section 1371(a)(4). Any regulations intended to deal with the first two possibilities should be promulgated independently of that section and should not be concerned with reclassification as a second class of stock.

III. Tax Advantages in Making Capital Contributions in the Form of Debt Rather Than Equity

A. Debt Used to Gain a Specific Tax Benefit

The major advantage arising from the use of debt in Subchapter C corporations is that the interest on the debt may be paid to the stockholders in the form of a disguised dividend—earnings and profits which would normally be included in the taxable income of the corporation may be deducted by the corporation as interest payments under section 163. Thus the double taxation of income is avoided. This tax benefit through the use of debt is not available to Subchapter S corporations since no tax is imposed at the corporate level.

Another widely recognized tax avoidance scheme in this area is income splitting. Debt could be used within a Subchapter S framework to achieve this purpose. For example, if a family owned corporation is capital-
ized primarily from debt contributions by a high tax bracket family member and the other family members contribute only a nominal amount of capital in return for the corporation's stock, the corporate income would be allocated only to the shareholders and thus taxed to them at a much lower rate than if it were allocated to the high tax bracket family member. In this situation, it might be argued that the debt contribution is in reality an equity contribution which should be classified as a second class of stock under the proportionality rule of Regulation 1.1371-1(g). However, if income splitting is the evil sought to be corrected, it can be done without requiring termination of the Subchapter S election. The Service has sufficient authority for correcting this evil through reallocation of the income without resort to the thin-capitalization reclassification doctrine.

If dividends have actually been distributed, the Commissioner could reallocate the amounts for tax purposes and treat any excess paid out to the lower tax bracket taxpayer as gifts. If the taxable income has not yet been distributed, the allocation would merely shift the amounts from one PTI account to another. Therefore, the government is protected from tax avoidance schemes and the taxpayer is protected from having to pay tax on income which he does not receive since accurate adjustments of PTI reflect the right to receive income on which he has already been taxed. Reclassification, then, would serve no meaningful purpose for either the taxpayer or the government.

Thus in these situations involving common and well-recognized schemes of tax avoidance, it should never be necessary to employ the thin-incorporation reclassification doctrine to invalidate the scheme when it is attempted in a Subchapter S context. General tax law will normally provide an adequate basis for remedying the evil. A problem, however, arises when a court must decide how to remedy the situation. Suppose the improper tax benefit which is sought to be corrected is so dependent upon the peculiar operation of the Subchapter S taxing provisions that the benefit is one which could not occur unless Subchapter S status were available. In such a situation, would it be proper to make that status unavailable by reclassifying debt to terminate the Subchapter S election?

B. Debt Used to Abuse the Subchapter S Statutory Scheme

As has been mentioned, debt could be used to create an eleventh
shareholder, a corporate shareholder, or an alien shareholder. Since Congress deemed it proper to limit the number of shareholders to ten, any increase in shareholders which violates this limitation automatically terminates the election. If an eleventh individual holds an interest in the corporation similar to that of ten undisputed shareholders except that his instrument is labelled debt, then a violation of the Subchapter S statutes exists. Debt has been used to gain the benefit of an eleventh shareholder—a benefit impermissible within the Subchapter S framework. In such a case, termination of Subchapter S status may indeed be the appropriate remedy.

Some commentators suggest another situation in which debt may be used to abuse the very scheme of Subchapter S. Essentially, it is contended that a benefit may be derived from manipulation of the net operating loss deduction. Since section 1374(c)(2) limits the availability of this deduction to an amount not exceeding the shareholder’s basis in his stock and debt, a shareholder might desire to increase his debt basis merely for the purpose of utilizing the availability of this deduction to the full extent of his pro rata share of this loss. This use of debt, considered independently, results in no improper tax advantage—Congress obviously intended such a benefit to be available to Subchapter S shareholders or it would not have enacted this provision.

The improper tax advantage is asserted to arise through the combined effect of section 1376 and section 1232. Section 1376 provides that a shareholder’s basis in both his stock and debt must be reduced to correspond with the amount of net operating loss he claims as a deduction—the stock basis being reduced first, then any basis in the debt being reduced. As pointed out previously, a shareholder may increase his debt basis for the purpose of taking full advantage of his pro rata share of the loss. In such a situation, when the shareholder uses the full loss deduction, his basis in both stock and debt would be reduced to zero. At some point in a subsequent tax year, the stockholder might withdraw the amount of the loan from the corporation in full repayment of the debt. Since the basis of the debt had been reduced to zero, repayment of the loan would produce taxable gain; however, section 1232 provides for capital gains treatment in the event of repayment of corporate indebtedness. Thus the shareholder would apparently reap the benefit of an ordinary tax deduction followed by a gain taxed at the capital gains rate.

The commentators who have emphasized this possibility have failed to analyze the problem completely. There are two possible situations in which this “supposed” tax benefit can occur.

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112 See, e.g., Bravenec, supra note 55, at 255; Caplin, supra note 23, at 193. But see Note, supra note 107, at 519.
1. The True Loan.—The shareholder loan may serve not only to facilitate the shareholder in taking advantage of the loss deduction, but also to benefit the corporation by providing necessary working capital at a time when business losses may have reduced its liquid assets. In this situation, the loan has a true business purpose. In all probability, the loan will not be repaid immediately unless the corporation has immediate profits. Such a loan is, then, at the risk of the business. If the corporation does make an immediate profit and does repay the loan, the shareholders will recognize a gain taxed only at the capital rate; however, despite the fact of the prior deduction at the ordinary rate, recognition upon repayment does not benefit the shareholder.

The loan is capable of being repaid because the corporation has made a profit. The profit, however, has produced taxable income. The shareholder will pay tax at ordinary rates on his share of that taxable income. If it is not distributed to him, the amount of his share of UTI will increase his stock basis, but not his debt basis. The result is that if the corporation then repays the shareholder loan, which because of the prior loss deduction has a reduced basis of zero, the shareholder will have to pay a capital gains tax on the full amount. Recognition of such gain at that time is in fact artificial and works to the advantage of the government rather than the taxpayer because he is being repaid from earnings and profits on which he has already paid tax at the ordinary rate.

An example might serve to clarify this point. Assume Corporation X, which is owned by A and B in equal shares, has a net operating loss for 1971 in the amount of $100,000. Each shareholder would be entitled to a $50,000 deduction on the basis of his pro rata share of that loss. However, if each had only a $20,000 stock basis and no current debt basis, he would not be able to take full advantage of the deduction. In order to take full advantage of the loss deduction and to provide the corporation with the needed working capital, assume that shareholder A lends the corporation $30,000. Then, assume that in 1972, Corporation X makes a profit of $100,000. This $100,000, less the $30,000 which is used to repay A, is retained by the corporation. Thus in 1972, A must report $50,000 of ordinary income which is his pro rata share of UTI. In addition, he must report $30,000 capital gain on the repayment of the loan.

The $50,000 ordinary income which A reported would increase his stock basis from zero to $50,000 and would also increase his PTI account by

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114 This, of course, assumes that the debt was evidenced by a note as required by section 1232.
115 In a Subchapter S corporation, $40,000 will represent the entire amount of capital since it represents not only the original capital contribution but also the amount of any profits retained by the corporation. Since a shareholder's stock basis is increased by his share of UTI, the stock basis necessarily includes that amount of retained profits which were taxable income in prior years.
$50,000. One might argue that, after all, he is not harmed by having to report a $30,000 gain upon repayment since he still has $50,000 available for tax-free withdrawal out of PTI. But this is not the case. Not only is the basis in stock and debt reduced by the amount of any loss deduction taken but PTI is also reduced by that deduction. Furthermore, PTI may be a negative amount. Thus in the above example, for the years 1971-72, shareholder A has reported an ordinary deduction of $50,000, a capital gain of $30,000, and an ordinary gain of $50,000.

Assume A's PTI account in 1971 had a zero balance. In that case the ordinary deduction would create a new balance of negative $50,000. The subsequent ordinary gain, represented by A's pro rata share of UTI, would increase this account, bringing the balance back to zero. The $100,000 profit in 1972 should have the effect of wiping out the $100,000 loss incurred in 1971. It should have the further effect of restoring the status quo completely for all who were financially affected by the loss. A's ordinary loss, for example, is offset by his subsequent ordinary gain. The loss is reflected by a reduction in his PTI account which is also offset by a subsequent increase in the PTI account. A's stock basis is reduced to zero by virtue of the loss, as is his debt basis. However, at this point the subsequent profit fails to reestablish the status quo. A's stock basis is increased, but his debt basis remains zero. Whether the Congress intentionally provided for this result in its enactment of section 1376 is unclear, but the effect is to work a hardship on A when his loan is repaid since he must recognize an immediate gain upon repayment.

However, A does have an inherent unrealized capital loss which could eventually offset this immediate capital gain. The basis in his stock is now $50,000. Prior to the tax events of 1971 and 1972, that basis was $20,000. Assume that in 1971 A's stock basis was exactly equal to the value of his stock—i.e., the corporation's net assets being worth $40,000. A's fifty percent interest was, then, worth $20,000. The loss of $100,000 on the part of the corporation, followed by a profit of $100,000 should, in simple theory, make the corporation's net worth exactly equal to $40,000, the value of its net assets prior to the 1971 loss and 1972 profit. The value of A's stock, then, would be $20,000. Yet because of the operation of section 1376, the stock has a basis of $50,000. The result is that A has an unrealized capital loss of $30,000 capital gain which he was forced to recognize upon repayment of the loan. This loss, however, will not be realized until such time as A disposes of his stock.

116 The stock basis had been reduced to zero when shareholder A took the full loss deduction in 1971.

117 Since the PTI account may be destroyed by a subsequent stock transfer in complete termination of interest, the taxpayer may never benefit from the mere existence of this account.


The commentators who suggest a possible tax benefit exists by virtue of the fact that section 1376 only increases a shareholder's basis in his stock have failed to consider the economic reality of the situation. If the loan is repaid from earnings and profits or is repaid at a time when earnings and profits are imminent, then in light of the above discussion, it should be clear that there is in fact no improper tax benefit to be derived from the use of debt. In fact, had A used stock rather than debt to increase his investment in the corporation, he might have been able to avoid immediate recognition upon repayment. His stock basis would have been increased by the subsequent earnings and profits. He then could have redeemed stock in order to recoup the $30,000 at no gain.139

2. The "Sham" Loan.—There is, however, another possible factual situation in which the use of debt for the purpose of utilizing the full amount of an operating loss may result in an unfair tax advantage. For example, Corporation X may have borrowed heavily from outside sources during 1971 so that in spite of the existence of the $100,000 loss in that year, the corporation has sufficient working capital available for the beginning of business in 1972. In such a situation, Shareholder A might lend the corporation $30,000 solely for the purpose of taking full advantage of his pro rata share of the loss. Six months later, the corporation is still doing badly. Yet A's loan is repaid, probably from funds which are owed to third parties. If earnings and profits are forthcoming, the economic situation will balance out as indicated in the preceding example. If they are not, the repayment of A's loan may present several problems totally unrelated to tax law.

Ignoring these collateral problems and analyzing the theory behind the availability of the loss deduction, one can consider the proper treatment of A's loan without taking into account the debt versus equity reclassification problem. Congress' evident intent was to allow the loss deduction up to the amount a shareholder has invested in the corporation, whether such investment be in the form of stock or debt. But the loan transaction must have some substance in order to justify its being used as a basis for the deduction. In the previous example, the shareholder is attempting to use a sham loan transaction to derive the benefit of an ordinary deduction. It might be said that he is using debt rather than equity to accomplish this purpose, since debt has the advantage of being more easily withdrawn than equity contributions. There are, it seems, two possibilities. If the loan is a sham, then the first benefit, the availability of the loss deduction, could be denied; or, since the fact is that debt has been misused in place of equity, perhaps it is the second benefit, the ease of withdrawal, which should be removed. At any rate, even in this second example where there is a possible improper tax benefit, it is not necessary to terminate the

139 For a further discussion of the possible consequences of stock redemptions in such a situation, see Bravenec, supra note 55, at 251.
Subchapter S election altogether in order to eliminate the impropriety.

In general, termination of Subchapter S election should not be used to punish a taxpayer for his improper use of debt if the impropriety can be remedied by some other method. Specifically, termination should not occur as the result of an artificial reclassification of debt as a prohibited second class of stock. Such a reclassification is proper only if debt is actually used to accomplish that which is prohibited by the one class of stock requirement.

IV. The Possibility of Using Debt to Thwart the Congressional Purpose of Section 1371(a)(4)

Section 1371(a)(4) does nothing more than prohibit the use of a second class of stock in Subchapter S corporations. Debt is not specifically mentioned. Thus there is no statutory prohibition against creating a debt instrument which grants preferential rights similar to rights which might be granted by the creation of a second class of stock. It is not the preferential rights in and of themselves which are prohibited. Rather, the statutory prohibition is aimed at eliminating certain complexities which might occur if such rights were coupled with an equity interest. Only if the debt interest creates the types of complexities which the statute seeks to avoid, should the debt be reclassified as a disqualifying second class of stock. That is, reclassification, followed by termination, is proper only if the effect of the debt contribution is to thwart the congressional purpose behind the one class of stock requirement.

A. Congressional Purpose in the One Class of Stock Requirement

When Subchapter S was enacted in 1958, there were no indications in the Committee Reports as to the rationale behind the one class of stock requirement. The Senate Report, however, does set forth the basic congressional intent, stating that the statute is meant to allow certain small businesses "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."111

The only direct comment on the one class of stock requirement comes from earlier committee hearings on proposals similar to those which were finally enacted as Subchapter S. The Treasury Department conducted two major studies on this type of optional taxation method for small business corporations as early as 1946 and 1947.112 Both these studies were reviewed by congressional committees.113 The one class of stock limitation was felt

113 Hearings on Community Property & Family Partnerships and on Corp. Tax Problems & Gen. Revisions Before the House Comm. on Ways & Means, 80TH CONG., 1ST Sess., PT. 1, At 1136-81 & PT. 5, At 3739, 3757-62 (1947) [Hereinafter Cited as Hearings].
to be necessary so that each shareholder would have equal control over any retained earnings which had been taxed to him previously. Furthermore, it was feared that allowance of more than one class of stock might present administrative problems relating to allocation of earnings:

For example, profits retained in one year in excess of accumulated claims of preferred stockholders would presumably be allocated to holders of common stock. Yet in a later year these funds might be used to pay dividends on preferred stock. Correction of this situation would require reopening returns or adjusting current year's income for all stockholders of the earlier year.\(^\text{124}\)

This same concern was later expressed in the Senate Report on a 1954 proposal which was the forerunner of Subchapter S:\(^\text{125}\)

In order to avoid possible complications in the taxation of preferred stock dividends not earned in the year distributed, only corporations having one class of stock outstanding may qualify.\(^\text{126}\)

... If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation’s current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an adjustment, however, would be extremely difficult where there had been a transfer of common stock in the interim.\(^\text{127}\)

Absent any further indications from Congress as to the reasons for this requirement, the conclusion from the foregoing would seem to be that a major concern behind the one class of stock requirement was to reduce administrative problems. The concern focuses on the problem of allocating present UTI for the determination of present tax liability. Different classes of stock might create different rights in relation to the later distribution of that UTI. The problem seems to be ultimately a question of whether it is equitable to tax a shareholder on income which may ultimately be distributed to someone else. The foregoing quotations seem to assume that it is not, and, on the basis of that assumption, to conclude that to make adjustments either prior or subsequent to such an inequitable occurrence would create severe administrative complications.

\(\text{124}\) *Hearings* at 1155.

\(\text{125}\) This proposal would have provided complete partnership tax treatment to a qualifying corporation. S. Rep. No. 1622, 83d Cong., 2d Sess. 118 (1954).

\(\text{126}\) *Id.* at 119.

\(\text{127}\) *Id.* at 453-54.
SUBCHAPTER S

The question of whether such assumptions or conclusions are warranted in light of the tax structure of Subchapter S is beyond the scope of this Note. However, summarizing the purpose as one aimed at avoidance of the type of inequitable results suggested in the above quotations, the following section will discuss the possibility of thwarting this purpose through the use of debt.

B. Is Reclassification Ever Proper in the Subchapter S Context?

It has been suggested that there are situations in which the use of debt should warrant termination of Subchapter S status; it has also been suggested that no such situations exist. The Internal Revenue Service’s position at the moment is unknown. On July 27, 1973, the Service issued T.I.R. No. 124831 which in effect suspended all litigation in this area pending a revision of Regulation 1.1371-1(g). Presumably, the government may still be working on the theory that reclassification of debt has a legitimate place in the Subchapter S context. The remainder of this Note will be directed to the basic issue of whether reclassification is ever proper in the Subchapter S context.

In suggesting that reclassification might be proper, the Fifth Circuit in Amory Cotton Oil Co. v. United States suggested three factors for consideration: (1) the general purpose of Subchapter S; (2) the fact that Subchapter S envisions stockholder loans; and (3) whether the particular use of debt serves a purpose within the contemplation of Subchapter S. To this list should be added a fourth factor: whether the particular use of debt thwarts the purpose of section 1371(a)(4). Moreover, if reclassification is to result in termination of the Subchapter S status, then it is this fourth factor which should be of greatest significance.

More than likely, under the current tax structure, the type of inequities which seemed to concern Congress would simply not occur, except to a slight extent. For instance, so long as a common shareholder’s PTI account is not reduced, he theoretically retains the right to a later tax-free distribution in that amount. If distributions are made to preferred shareholders which do not come from current earnings and profits or accumulated earnings and profits, presumably they could represent a return of basis, with any excess over basis being treated as capital gain under the provisions of section 301. Of course, the actual source of funds so distributed may be retained earnings which are represented by the PTI accounts. This might result in the lack of actual funds which can be distributed to the common shareholders in satisfaction of their PTI accounts. The result will be a loss in actual value of the common stock—a loss which will not be recognized until the stock is ultimately disposed of. Of course it is possible that the loss may be a capital one whereas the shareholder has been paying tax on ordinary gains, a seemingly inequitable exchange. If the stock is section 1244 stock, however, (and there is no reason why it should not be), the loss will be an ordinary one.

See, e.g., Bravenec, supra note 55, at 255; Caplin, supra note 23, at 193.

See Note, supra note 107, at 519.

7 CCH 1973 STAND. FED. TAX REP. ¶ 6754.

468 F.2d 1046 (5th Cir. 1972).

Id. at 1051-52.
The main problem with which Congress seemed to be concerned was the problem of “PTI leakage”—i.e., it might be possible for common stockholders to pay tax on income, build up a PTI account, and yet never reap the benefits of the PTI account if corporate funds are subsequently distributed to preferred shareholders.

Although this type of “PTI leakage” may occur to a limited extent if preferred stock exists, this does not mean it will occur if debt is used instead. It certainly cannot occur in situations in which interest is paid out of current earnings. Funds to support the PTI account, which represents prior earnings, will not be affected by any payments made out of current earnings.

If interest payments are made in the absence of current earnings, the effect will be the creation of a net operating loss. If the stockholdings have remained constant, the shareholder is not harmed by this type of interest payment in that the net operating loss will be passed on to the shareholders as an ordinary deduction to the extent of their adjusted bases in stock and debt. Thus a shareholder in such a situation would be fully compensated for any PTI he did not directly receive, since that PTI would be matched by the net operating loss deduction.

When there has been a partial transfer of a stockholder's interest after PTI has accumulated; however, the problem of PTI leakage appears to have more substance. This results from the fact that a shareholder's share of PTI may no longer be proportionate to his share in any net operating loss deduction that may become available through the payment of interest. This situation occurs because the regulations provide that a shareholder's PTI is not reduced by a sale of stock unless the sale is a complete termination of interest.\[134\] This excess PTI, reflecting prior earnings on stock which the shareholder no longer owns, appears to be subject to leakage since, not reflecting the shareholder's present stock basis, it represents an amount which cannot be employed in utilization of the net operating loss deduction.

However, even though the possibility of leakage exists, it may not represent an inequity of the type that concerned Congress. Since a shareholder's basis in his stock is increased by each addition to PTI, when he sells part of his stock, that share of PTI attributable to the stock sold is presumably accounted for in the sale. Of course, were he to sell the stock for less than its basis, he might have only a capital loss to offset the ordinary gain he had reported earlier.

Another type of inequity might be caused by the use of debt which resembles something like preferred stock. Consider the following example: Corporation $AB$ needs more capital. $X$, a non-shareholder, lends the corporation $10,000 on the following terms: interest is to be five percent of the

corporation's net profits, payments to begin on a date three years hence, a minimum of $1,000 annually to be guaranteed; no distributions can be made to common stockholders until this interest is paid; the note is payable on demand only after a ten year period; and, the corporation may not repay it before that time.

It is apparent that such an instrument creates substantial and immediate rights in X to the future corporate profits. However, since he is not a shareholder, none of the income in the first three years will be taxed to him. The instrument in reality is a very preferential second class of stock. Furthermore, failure to reclassify it as such gives rise to a possible inequity to the common shareholders. They are bearing the tax burden of current profits which they must leave in the corporation. The retention of these profits presumably will work to increase later profits, in which X will share. However, if X's debt is reclassified as stock in order to allocate a percentage of present corporate income, it will result in the same type of complexity that section 1371(a)(4) seeks to avoid and for which the regulations do not provide. Because of the specific provisions accompanying X's obligation, it would be extremely difficult to allocate to him the amount of present tax burden he should bear. His eventual participation in corporate profits may amount to only five percent. But, assuming low profits, the $1,000 guarantee may amount to more than five percent.

Perhaps this is a situation where denial of Subchapter S status is the proper remedy. Admittedly such a situation would be rare. And in this case, since the inequity is one to the common shareholders, it is unlikely that the Commissioner would concern himself with reclassification—unless of course the reclassification also resulted in a tax benefit to the government.

V. Conclusion

Whether or not a situation such as the one described above is likely to occur is not the main focus of this Note. It is sufficient to recognize that there is a possibility, however slight, that a situation may occur in which reclassification of debt should result in denial of Subchapter S status. Hopefully, this Note provides guidelines for determining whether such a situation does in fact exist. The specific type of tax avoidance involved—not tax avoidance in general—must be considered. Finally, to terminate the election pursuant to section 1371(a)(4), the debt instrument must create the particular type of inequity that the one class of stock requirement seeks to avoid.

The proposed regulation should be based on a sound consideration of this fact. One commentator has suggested the following rule:

Obligations that purport to represent debt but which actually represent equity capital will not generally constitute a second class of stock. If the principal purpose of the use of purported debt obligations
is the avoidance or evasion of tax, however, such obligations may be
demed a second class of stock, but only if the avoidance or evasion
of tax cannot be otherwise remedied.\textsuperscript{135}

Although such a rule is indeed preferable to the regulation as it now
stands, such a rule cannot be based on the authority of section 1371(a)(4).
That section is not concerned with the avoidance or evasion of tax in
general. It is only concerned with tax consequences of a certain type. Tax
avoidance or evasion in general should be dealt with directly rather than
through an indirect and artificial reclassification which culminates in ter-
mination pursuant to section 1371(a)(4). Instead, the proposed regulation
should provide for reclassification only in cases in which the use of debt
hinders fair and accurate allocation of current income.

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