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Taxation--Subchapter S--Relaxation of the One Class of Stock Requirement

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CASE COMMENTS

Taxation — Subchapter S — Relaxation of the One Class of Stock Requirement

Shores Realty Company, a Florida corporation incorporated in 1960 for the purpose of developing real estate, filed a timely election to be taxed as a small business corporation under Subchapter S of the Internal Revenue Code of 1954. Four shareholders, Raymond V. Guernsey and his wife, and Emerson D. Wertz and his wife, owned equal amounts of the corporation's stock. To complete the financing of the corporation, the shareholders made disproportionate advances of funds for which they were issued unsecured demand notes.¹ Acting pursuant to Treasury regulation section 1.1371-1(g),² the Commissioner determined that the loans to the corporation constituted equity and a second class of stock. The company therefore was not entitled to Subchapter S treatment.³ Accordingly, deficiencies were assessed; these were paid and the company sued for a refund. The district court determined that the advances did not constitute a second class of stock;⁴ on appeal the Fifth Circuit *held*, affirmed.

Although the Court correctly characterized the advances as

¹ The advances were carried on the taxpayers' books as loans and were made in a series commencing on March 18, 1960. The unsecured demand notes provided for interest at the rate of 6% annually. The note indicated corporate debts amounting to \$30,000 to Emerson D. Wertz, \$11,000 to Raymond V. Guernsey, and \$17,000 to Guernsey Investment Company, a business owned by Guernsey and his wife. Neither Mrs. Wertz nor Mrs. Guernsey made any individual contributions.

² Treas. Reg. § 1.1371-1(g) (1967) states:

A corporation having more than one class of stock does not qualify as a small business corporation. . . . 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. But, if an issuance, redemption, sale, or other transfer of nominal stock, or of purported debt obligations which actually represent equity capital, results in a change in a shareholder's proportionate share of nominal stock or his proportionate share of such purported debt, a new determination shall be made as to whether the corporation has more than one class of stock as of the time of such change.

³ For the corporation to continue to qualify, it must not at any time subsequent to the election fail to meet the initial qualification requirements, including the requirement that the corporation have only one class of stock. INT. REV. CODE OF 1954, § 1372(e)(3).

⁴ *Shores Realty Co. v. United States*, 71-1 U.S. Tax Cas. ¶ 9211 (S.D. Fla. 1971).

equity, it found that they did not constitute a second class of stock. Given a Subchapter S situation, the application of debt-equity analysis and the proportionality standard in Treasury regulation section 1.1371-1(g) was improper and exceeded the Commissioner's authority. *Shores Realty Co. v. United States*, 468 F.2d 572 (5th Cir. 1972).

Subchapter S of the Code was enacted in 1958 to permit businesses "to select the form of business organization desired without the necessity of taking into account major differences in tax consequence."⁵ Instead of accomplishing this purpose, Subchapter S has created a number of unique tax problems. To qualify for Subchapter S exemption, several basic requirements must be met by the electing corporation.⁶ If, at any time, the corporation is found to have violated any one of these requirements, it will be subject to taxation under Subchapter C.⁷ This may force the corporation to pay unplanned additional taxes.

The one class of stock requirements,⁸ as interpreted by the Commissioner, poses particular problems for the electing business. In the regulations, the Commissioner states that "[o]bligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock."⁹ This has led to the application of debt-equity analysis¹⁰ to Subchapter S corporations.

⁵ S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

⁶ INT. REV. CODE OF 1954, § 1371(a), states that a small business corporation electing Subchapter S status must not:

- (1) have more than 10 shareholders;
- (2) have as a shareholder a person (other than an estate) who is not an individual;
- (3) have a non-resident alien as a shareholder; or
- (4) have more than one class of stock.

⁷ INT. REV. CODE OF 1954, § 1372(e)(3). A termination of the Subchapter S election will also cause a "locked-in earnings" problem. Any earnings and profits upon which the shareholder has paid taxes but which have not been distributed, will be subject to taxation as a dividend under § 301 if distributed by the corporation to the shareholders after termination of the election. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS, ¶ 6.08 (3d ed. 1971).

⁸ INT. REV. CODE OF 1954, § 1371(a)(4).

⁹ Treas. Reg. § 1.1371-1(g) (1967). See note 2, *supra*.

¹⁰ There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money;

Treasury regulation section 1.1371-1(g) originally indicated that if the Commissioner found that purported debt was actually equity, it would be considered a second class of stock.¹¹ Several cases upheld this view,¹² but in 1966 the tax court found the regulation partially invalid. In *W.C. Gamman*,¹³ the court held that though some debt instruments might represent equity capital, they would not be found to constitute a second class of stock if the advances were made and the notes held by shareholders in direct proportion to their interests.¹⁴ In 1967, the Commissioner amended the regulation in compliance with the *Gamman* holding,¹⁵ but he has had little success applying the amended regulation. In 1968, the tax court indicated that the shareholders' intent to make the loans proportionately was sufficient to prevent the creation of a second class of stock.¹⁶ In 1970, the court took another step toward invalidating Treasury regulation section 1.1371-1(g). In *James L. Stinnett, Jr.*,¹⁷ the tax court refused to find the proportionality requirement controlling. The majority found that an instrument purporting to represent debt, which amounted to a simple installment note having none of the incidents commonly attributed to stock, did not constitute a second class of stock simply

(11) the ability of the corporation to obtain loans from outside lending institutions.

O. H. Kruse Grain & Milling Co. v. Comm'r, 279 F.2d 123, 125-26 (9th Cir. 1960).

¹¹ The regulation in question originally stated: "If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock." Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.

¹² *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965); *Catalina Homes, Inc.*, 23 CCH Tax Ct. Mem. 1361 (1964).

¹³ 46 T.C. 1 (1966); *accord*, *Lewis Bldg. & Supplies, Inc.*, 25 CCH Tax Ct. Mem. 844 (1966).

¹⁴ 46 T.C. at 9. *Gamman* was the subject of considerable commentary and gave rise to a discussion of the applicability of debt-equity analysis to the Subchapter S situation. The *Gamman* decision is analyzed in Note, *Shareholder Lending and Tax Avoidance in the Subchapter S Corporation*, 67 COLUM. L. REV. 495 (1967); Comment, *Debt Obligation of Subchapter S Corporation Held not to Constitute Second Class of Stock*, 41 N.Y.U.L. REV. 1012 (1966); Comment, *Shareholder Advances to "Thin" Subchapter S Corporations*, 19 STAN. L. REV. 628 (1967); Comment, *Subchapter S—Classes of Stock*, 20 SW. L.J. 234 (1966); Comment, *Thin Incorporation Not Tantamount to Disqualification From Subchapter S*, 19 VAND. L. REV. 1401 (1966); Comment, *Disputed Uses of Debt by Subchapter S Corporations*, 41 WASH. L. REV. 856 (1966).

¹⁵ Treas. Reg. § 1.1371-1(g) now states that purported debt obligations which the Commissioner finds to represent equity capital will not be considered a second class of stock if held by the shareholders in proportion to their shares of the nominal stock in the corporation. See note 2, *supra*.

¹⁶ *Milton T. Raynor*, 50 T.C. 762, 769 (1968).

¹⁷ 54 T.C. 221 (1970). The tax court followed the *Stinnett* decision in *Estate of William M. Allison*, 57 T.C. 174 (1971), and *H. R. Spinner Corp.*, 29 CCH Tax Ct. Mem. 462 (1970).

because the debt created disproportionate rights among the shareholders to corporate assets.¹⁸

The decision in *Shores Realty* made the validity of section 1.1371-1(g) even more questionable. The Commissioner argued that by applying debt-equity analysis to the loans made by the shareholders of Shores Realty Company, it became evident that the purported debt constituted equity. Equity capital that was given disproportionately by the shareholders created rights upon corporate distributions and liquidation that made the purported debt obligations preferred over common stock; but the common stock retained a preference as to voting rights. The Commissioner reasoned that these characteristics of preferred stock were sufficient cause for him to reclassify the purported debt and regard it as a second class of stock. The court disregarded the proportionality criterion, stating that it found no support for the proposition that Congress, in adopting Subchapter S, had intended to create such a standard. The court also noted that section 1376(b)(2)¹⁹ of the Code is indicative of congressional intent to allow loans to a small business corporation by its stockholders.

The court in *Shores Realty* essentially followed *Stinnett*²⁰ but took one additional step. It concluded that there was "no basis in law" for the Commissioner's attempt to inject debt-equity analysis into the application of the one class of stock requirement.²¹ The court's reasoning was based on the legislative history of Subchapter S and the lack of evidence of legislative concern with the debt-equity capitalization problem in the history of the one class of stock requirement.²²

¹⁸ 54 T.C. at 232. The *Stinnett* decision, like *Gamman*, has been the subject of commentary. Note, *Disproportionate Advances by Shareholders of Subchapter S Corporation and the One Class of Stock Requirement*, 31 LA. L. REV. 510 (1971); Comment, *The One-Class-of-Stock Requirement of Subchapter S and the Invalidation of Treasury Regulation 1.1371-1(g)*, 50 B.U.L. REV. 577 (1970).

¹⁹ INT. REV. CODE of 1954, § 1376(b)(2) states that:

The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the adjusted basis of the stock of such corporation held by the shareholder.

²⁰ 54 T.C. 221 (1970).

²¹ *Shores Realty Co. v. United States*, 468 F.2d 572, 577 (5th Cir. 1972).

²² The one class of stock requirement appears to have been included largely because of a desire on the part of Congress to avoid the administrative complexities inherent in the allocation of rights, profits, and responsibilities where

On the same day that *Shores Realty* was decided, a second panel of judges in the Fifth Circuit came to a different conclusion as to the applicability of debt-equity analysis to the Subchapter S corporation. In *Amory Cotton Oil Co. v. United States*,²³ the court concluded that a true inquiry can be made only when debt-equity is viewed in conjunction with "the underpinnings of Subchapter S and the rationale of the one class of stock requirement."²⁴ The court, however, refused to accept the proportionality requirement for shareholder loans and ruled that section 1.1371-1(g) is "both facially and in its application in this case . . . arbitrary and beyond the power of the Commissioner."²⁵

The Seventh Circuit has recently joined the Fifth Circuit in overruling section 1.1371-1(g). In *Portage Plastics Co. v. United States*,²⁶ the Seventh Circuit, sitting en banc, reversed a two to one decision by a three-judge panel that had upheld the Commissioner's application of the regulation.²⁷ The court indicated that the thin

more than one class of stock is involved. An analysis of the Senate Reports in which this requirement was discussed may be found in McGaffey, *The Requirement that a Subchapter S Corporation May Have Only One Class of Stock*, 50 MARQ. L. REV. 365, 366-70 (1966). A discussion of the debt-equity characterization problem, with alternative methods of applying this approach to the one class of stock requirement, and the possible tax consequences of such application may be found in Bravenec, *The One Class of Stock Requirement of Subchapter S—A Round Peg in a Pentagonal Hole*, 6 HOUS. L. REV. 215, 242-46 (1968).

²³ 468 F.2d 1046 (5th Cir. 1972). The corporation had elected to be taxed as a Subchapter S corporation. The Commissioner sued for deficiencies in income tax payments, alleging, as in *Shores Realty*, that disproportionate advances had been made to the corporation by the stockholders in such a manner as to amount to a second class of stock. The corporation paid the deficiencies and sued for refund of \$108,834.52.

²⁴ *Id.* at 1054.

²⁵ *Id.* The court in *Shores Realty* also held Treas. Reg. § 1.1371-1(g) to be invalid. 468 F.2d at 578.

²⁶ 73-1 U.S. Tax Cas. ¶ 9261 (7th Cir. 1973). Two individuals, who were not shareholders in the electing corporation, made advances of \$25,000 to the corporation in 1957. The articles of incorporation had originally authorized the issuance of \$10,000 worth of stock. In 1962, the articles were amended to authorize the issuance of an additional \$190,000 worth of stock at par value. The notes taken by the individuals made no provision for the repayment of the amounts advanced in the event of default. Each individual had the right to renew their note at the end of five years. They were to be paid "interest" amounting to 5% of the corporation's net profits before taxes. Both subordinated their notes to bank loans to the corporation. The interest was paid until 1963 when the instruments were exchanged for common stock in the corporation.

²⁷ 470 F.2d 308 (7th Cir. 1972). This three-judge panel had reversed a lower court decision against the Commissioner. In the latter decision, the district court had applied debt-equity analysis and determined that the purported loans amounted to equity capital but had refused to find that they represented a second class of stock. The majority of the circuit court panel indicated that the failure to take this step was error and attempted to distinguish this case on its facts from the cases decided by the Fifth Circuit.

capitalization doctrine could still be applied in the Subchapter S context "where appropriate to deny particular tax benefits wrongfully taken in those cases where tax avoidance through the use of debt is still available. . . ."²⁸ It refused, however, to apply the debt-equity criteria where the only issue was whether a purported debt should be considered a second class of stock.

Judicial disapproval of the Commissioner's approach to the one class of stock requirement has now been clearly indicated. Still, until the regulation is changed or until each circuit has had the opportunity to rule on its validity, the possibility remains that it may be resurrected and enforced.

Congressional action to clarify Subchapter S seems the logical solution to the problem. The potential for dispute in this area has been recognized since Subchapter S was enacted,²⁹ and many proposals for change have been made;³⁰ yet, the law remains as it was adopted in 1958. Given the failure of Congress to effect legislative reform in this area and the confusion in the courts over the applicability of debt-equity analysis to Subchapter S corporations, the safest approach is to comply whenever possible with the Commissioner's standards as stated in the regulation. If it is necessary for the small business corporation to borrow from its shareholders, the loans should be made proportionate to the holding of stock. The corporation should carefully comply with the debt-equity standards used by the Commissioner; the debt should always "be represented by unambiguous instruments

²⁸ 73-1 U.S. Tax Cas. 9261 n.3 (7th Cir. 1973).

²⁹ Caplin, *Subchapter S and Its Effect on the Capitalization of Corporations*, 13 VAND. L. REV. 185 (1950).

³⁰ One authority contends that Subchapter S is defective and ought to be repealed. He argues that its repeal should be accompanied by the enactment of a law permitting the extension of the partnership provisions to such corporations. 7 J. MERTENS, FEDERAL LAW OF INCOME TAXATION § 4113.44 (Malone rev. ed. 1967). A second alternative that has been advocated is simply to allow the Subchapter S corporation to have more than one class of stock. Pennell, *Subchapter S—The Need for Legislation*, 24 TAX LAWYER 249 (1971). The problem in this area was recognized by the committee proposing changes in the tax laws to be incorporated into the Tax Reform Act of 1969. It proposed that "the existence of any interest not designated as stock, which has neither voting rights nor rights to distributions beyond a fixed annual interest rate and a fixed amount upon redemption or payment, will not cause the corporation to be disqualified even if the interest is determined to be equity capital." *Hearings on Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 14, at 5232 (1969). This proposal was not adopted. For an analysis of the changes to Subchapter S that were suggested for the Tax Reform Act of 1969, see Rosenkrantz, *Subchapter S: The Presidential Proposals*, 55 A.B.A.J. 1181 (1969). Criticism may be found in Note, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 806-09 (1971).

which include, at least, a definite maturity date and reasonable interest provisions and on which prompt payments are made."³¹

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³¹ Note, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 808 (1971). More detailed suggestions for making loans to Subchapter S corporations without violating Treasury regulation section 1.1371-1(g) may be found in Odmark, *A Practitioner's Guide to Subchapter S Planning Opportunities and Pitfalls*, 30 J. TAXATION 360, 362 (1969).