The Dilemma of Subchapter S

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NOTES

THE DILEMMA OF SUBCHAPTER S

Section 1371(a) of the Internal Revenue Code\(^1\) provides, in part:

Small Business Corporation.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

(1) have more than ten shareholders;
(2) have as a shareholder a person (other than an estate) who is not an individual;
(3) have a nonresident alien as a shareholder; and
(4) have more than one class of stock.

One of the apparent objectives of Subchapter S of the Internal Revenue Code,\(^2\) of which Section 1371(a) is a part, was to permit certain businesses (hereafter referred to as subchapter S corporations) to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences.\(^3\) Thus, the shareholders of a subchapter S corporation are permitted to deduct the operating losses of the corporation or to include the income of the corporation on their individual returns without any tax consequence to the corporation.

Within this framework, it is to be noted that a corporation can qualify as a subchapter S corporation only if it has but one class of stock outstanding.\(^4\) The last sentence of Regulation 1.1371-1(g)\(^5\) provides with respect to this requirement:

If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.

The Commissioner's Regulation has been supported in the cases of Catalina Homes, Inc.\(^6\) and Frederick Henderson.\(^7\) Nevertheless, in relatively recent decisions of the Tax Court of the United States—Gamman\(^8\) and Lewis Building and Supply Company, Inc.\(^9\)—the Tax Court failed to sustain the validity of the regulations. Consequently, on December 27, 1966, this regulation was amended\(^10\) to conform with the Gamman and Lewis decisions.

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2 Subchapter S—Election of Certain Small Business Corporations as to Taxable Status.
4 Supra note 1.
5 Treas. Reg. § 1.1371-1(g) (1959).
7 245 F. Supp. 782 (M.D. Ala. 1965), appeal dismissed per stipulation.
8 46 T.C. 1 (1966), appeal dismissed per stipulation.
10 The regulation, as amended, provides, in part:
Prior to *Gamman* and *Lewis*, the regulation was interpreted so that if a debt obligation was equity capital,\(^1\) it was a second class of stock as a matter of law. In *Gamman* and *Lewis*, however, the Tax Court recognized that although advances to a corporation may be equity capital, as opposed to debt, it does not necessarily follow that a second class of stock was created. The majority opinion in *Gamman* said,

... We 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 holders of the nominal stock.

When the Commissioner amended the regulation to conform with the *Gamman* and *Lewis* decisions, however, the dilemma of subchapter S did not end. There remained the problems of:

1. Whether holding stockholder advances to a subchapter S corporation as a second class of stock defeats the inherent purpose of Subchapter S, that is, to allow small businesses to take advantage of the corporate form of doing business, but to be taxed as a proprietorship or partnership;
2. Whether the similarity between the nature of a debt obligation and a class of stock other than common stock will add to the complexity of the problem;
3. Whether profitable corporations who repay their debts will be

Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock. 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. (Reg. § 1.1371-1).


\(^1\) The capital of a business corporation is provided by two main groups: (1) those who lend funds for stated periods at an agreed rate of interest; and (2) those who contribute the layer of buffer or equity capital. The first group, the creditor investors (usually bondholders or noteholders), have claims to income and principal based on contract rights which are senior to the claims of the second group. Further, they take no part in the administration of the business unless their rights are impaired. The second group is represented by the common stockholders who shoulder the risk of loss and the underlying responsibility for direction of the corporate activity (through their representatives, the board of directors and officers of the corporation). Preferred stockholders are in between the two groups because they occupy a position subordinate to the creditors but superior to the common stockholders with respect to participation in income and recovery of investment. All other rights of preferred stockholders are determined by their contract with the corporation. See Paton, *Corporation Accounts and Statements* § (1955).
automatically hindered because of the preferential treatment afforded to such advances; and

(4) Whether the issue of debt versus equity which has been traditionally applied to prevent the avoidance of double taxation by an ordinary corporation which pays out dividends in the guise of deductible interest and repayments of the purported debt should be applicable in a subchapter S situation where there is no double tax.

To properly understand this current dilemma of Subchapter S, it is necessary to review these four major cases which preceded the amendment of the Regulations. In the case of Catalina Homes, Inc., the corporation was formed with a capital of $10,000 to construct and sell one family homes. Two shareholders controlled all of the voting power through direct ownership and a voting trust agreement with the other shareholders. During the sixteen months after incorporation, $70,000 was advanced to the corporation in proportion to the voting power. There was no instrument of indebtedness or security for the loan, but an agreement existed between the two voting shareholders that the loans were to bear interest at five per cent to be payable as determined by the board of directors and no dividends were payable by the corporation until there was full payment of principal and interest. The Tax Court determined that the loans constituted a second class of stock of the corporation, and that, as a result, corporate earnings were subject to the corporation federal income tax. In determining that the nature of the advances were contributions to capital, Judge Fay said:

When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business. To conclude that the advances were a second class of stock, the court relied on provisions of the stockholders' agreement that the five per cent interest was payable as determined by the board of directors and the advances were preferred over the no-par common stock to the extent that dividends were not payable until the advances had been paid in full.

In Henderson, three individuals contributed capital of $3,000 upon the formation of Henderson Mining Company. A timely election was filed by the corporation to be taxed as a subchapter S corporation. After the board of directors authorized a corporate indebtedness of $150,000, the stockholders made pro rata advances of $60,000 to purchase equipment essential to the corporation's initial operation. In exchange, unsecured

12 Supra note 6.
13 The corporation, Century House, with the consent of all its stockholders filed the election pursuant to section 1372(a) of the Internal Revenue Code not to be subject to Federal Income Tax.
demand promissory notes bearing eight per cent interest were executed in favor of the stockholders. Judge Johnson said:

The sole questions involved concern whether or not certain advances . . . were loans or contributions to capital. The subsidiary question, usual in such cases, concerning whether the advances in effect created a separate class of stock is also involved in the present submission.

After noting that the advances were essential to the inception of the corporate venture, the amounts were in relationship to the stock ownership, security did not exist, effort was not made to enforce the alleged loans, repayments were long overdue and the money was used to purchase equipment essential to the corporate operation, the court held with respect to the former question that the shareholders intended to take the risk incident to a capital investment when they made the advances to the corporation. As to the subsidiary question, the court found, without explanation, that the instruments received by the shareholders in exchange for the advances constituted a second class of stock, and, consequently, that the Henderson Mining Company did not qualify as a subchapter S corporation. Thus, the shareholders were not entitled to deduct the net operating loss of the corporation on their individual income tax returns.

Then, on April 4, 1966, the Tax Court faced for the first time, in Gamman, the argument by the taxpayer that section 1.1371-1(g)10 of the Regulations was invalid. In that case, two individuals paid $200 each to the subchapter S corporation for all of the capital stock, and within three months after incorporation, in October of 1959, had also made $28,000 in advances to the corporation in return for demand notes bearing six per cent interest. The corporation was formed to operate a motel near the proposed site of the World’s Fair in Seattle. When substantial losses were incurred during 1960, 1961 and 1962, the shareholders made additional pro rata advances evidenced by six per cent demand notes, so that the total advances exceeded $250,000 by the end of 1962. The Commissioner disallowed the corporate losses deducted by the shareholders, contending that the shareholder advances were a six per cent preferred nonvoting stock, a second class of stock and, consequently, that the corporation did not qualify as a subchapter S corporation.

In a majority opinion written by Judge Drennan, the court held that the last sentence of Regulation’s section 1.1371-1(g) was invalid as being inconsistent with the purpose and intent of Congress in enacting Section 1371 of the Internal Revenue Code. Judge Drennan said:

. . . . We find nothing in the law itself, the committee reports, or

16 See cases cited id. at 783, n. 2.
17 Id. at 783.
19 Treas. Reg. § 1.1371-1(g) (1959).
the assumed purpose of the legislation that would justify holding arbitrarily or per se, that all instruments which purport to be debt obligations, but which in fact represent equity capital, must be treated as a second class of stock for purposes of section 1371.20

The court agreed with the Commissioner's reliance on the so-called thin capitalization cases21 that the purported loans were in substance contributions to capital, although in form they were debt obligations. The court proceeded, however, to the second issue of whether the advances were equity capital or a second class of stock, as a matter of fact.22 From the facts that the notes were in proportion to the stockholdings, the terms of the notes (interest and repayment upon demand) were waived, the notes did not give the holders any right to vote or a voice in management of the corporation and "... whatever preferences the notes gave the noteholders in the income and assets of the corporation, if enforced, were preferences only over themselves as stockholders,"23 the court concluded that "these advances were placed at the risk of the business just the same as the amounts petitioners paid for the capital stock,"24 and were not a second class of stock.

Three judges concurred with the result, but were of the opinion that the Regulation's section 1.1371-1(g) was valid because the regulation itself required the conclusion reached. They found that the notes were not "actually stock," that is, they did not have the character of stock. The notes and interest, unlike common stock and dividends, were payable on demand; interest was payable from the corporate assets unlimited by earnings; and interest was fixed in amount and time of payment.25 These judges agreed, however, that the notes represented equity capital and not debt instruments.

Judge Dawson, also concurring, added that the second class of stock requirement was inconsistent with "the legislative history of Subchapter S, which indicates that the single class of stock requirement was imposed primarily to avoid the necessity for complex rules of allocation."26

The dissenting opinion of five Tax Court judges said that the regulation in question was consistent with the statute because it is within the

20 Gamman, supra note 18, at 7.
21 O.H. Kruse Grain & Miyling v. Commissioner, 279 F.2d 123 (9th Cir. 1960); Rowan v. United States, 219 F.2d 51 (5th Cir. 1955); Nassau Lens Co. v. Commissioner, 308 F.2d 89 (2d Cir. 1962); Gilbert v. Commissioner, 348 F.2d 399 (2d Cir. 1957); and 2554-58 Creston Corp., 40 T.C. 932 (1963).
22 In Henderson and Catalina Homes, Inc., the courts, in complying with the Commissioner's Regulations, held that if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock, as a matter of law.
23 Gamman, supra note 18, at 6. See also Pepper v. Litton, 308 U.S. 295, 84 L. Ed. 281 (1939).
24 Gamman, supra note 18, at 6.
25 On the other hand, dividends are payable only at a time fixed by and in an amount designated by the board of directors.
26 46 T.C. 1, 9 (1966).
Commissioner's power to define the statutory phrase "one class of stock," and since these instruments established different rights and liabilities from those associated with the corporation's common stock, it was entirely appropriate to conclude that they represented a second class of stock\(^2\) within the meaning of the Regulations.

On June 30, 1966, the Tax Court, in *Lewis Building and Supplies, Inc.*,\(^2\) was again confronted with the question of whether advances by shareholders to a subchapter S corporation constituted a second class of stock. The corporation was established in 1959 with paid in capital of $1,000. During 1959 and 1960, the shareholders owning seventy per cent of the capital stock advanced $12,500 to the corporation and the shareholders owning thirty per cent of the stock advanced $6,000, in exchange for which they received non-interest bearing demand notes purporting to be loans. In determining that the advances created an equity interest and not a debt, the court looked at the facts that there was no maturity date, demand for payment was never made, interest was payable only on demand, no interest was ever paid or accrued, capitalization was comparatively thin (the debt-equity ratio was relatively high), and advances were substantially proportionate to stock ownership. Then, as to whether the advances were a second class of stock or simply represented equity contributions, the court, pursuant to the holding of *Gamman*, held that this was a question of fact. As such, because the holders had no rights or interests different from the owners of the nominal stock, the advances were determined to be equity contributions and not a second class of stock.

When the Commissioner, on December 27, 1966, amended his regulations\(^2\) to conform with the holdings of the Tax Court in *Gamman* and *Lewis Building and Supplies, Inc.*, the government, on its own motions, dismissed its appeals in those two cases.\(^3\) Similarly, the government conceded *Henderson*\(^4\) upon the taxpayer's motion to dismiss.\(^5\)

The Commissioner has thus decided to adopt a case by case approach based upon the answers to two issues of fact:

1. Whether the advances to the corporation are debt or equity capital?
2. If the advances are equity capital, do they constitute a second class of stock?

In answering the first issue, many criteria have been developed from the case law,\(^6\) such as:

\(^2\) Judge Raum said, "As thus modified the notes resemble cumulative non-participating redeemable preferred stock." *Id.* at 14.

\(^2\) See text of amended regulation in note 10, *supra*.


\(^5\) *Supra* note 30.

\(^6\) See, e.g., Hambuechen, 43 T.C. 90, 99 (1964), and O.H. Kruse Grain & Milling Co.
(1) the adequacy of the capitalization;
(2) the formal provisions of the note;
(3) security for the loan;
(4) reasonableness of expectation of repayment;
(5) the use to which the funds are put;
(6) the dependency of repayment on corporate profits;
(7) the proportionality of the advances to stock ownership; and
(8) the need for the funds in the conduct of the business.

Further, the court, in United States v. Title Guarantee & Trust Co., in considering the distinction between a stockholder and a creditor, said:

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate venture, taking the risks of loss upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided but merely to lend his capital to others who do intend to take them.

As a result, in answering the first issue, the courts will have sound criteria upon which to render a decision.

Many problems are certain to arise, however, in determining the ultimate question, which is, if the advances are contributions to capital, do they constitute a second class of stock? The amended regulations attempt to solve this problem by developing the following criteria for the existence of a second class of stock:

(1) A difference between the voting rights, dividend rights, or liquidation preferences;
(2) The general assumption by the Commissioner that obligations which purport to represent debt but which actually represent equity capital will constitute a second class of stock; and
(3) A lack of proportionality between the ownership of the nominal stock and the ownership of the purported debt obligation.

Catalina Homes, Inc., presented a strong case for the Commissioner, even in applying the new regulations. From such facts that the advances were made to the corporation within a short time after incorporation, the amount of equity ($10,000) was inadequate to meet the permanent requirements of the business (constructing and selling homes), and there was no instrument of indebtedness, the conclusion is inescapable that the advances were contributions to capital. Then, because the advances were disproportionate to stock ownership, the dividends (disguised in the form of

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34 133 F.2d 990 (6th Cir. 1943).
35 Id. at 993.
36 See Treas. Reg. § 1.1371-1(g) (1967).
interest) were similarly disproportionate, voting power was disproportionate to the stock ownership (pursuant to an agreement between two of the shareholders), and because dividends were to be paid only after these purported debts were repaid, it would not be difficult to find that the purported debt constituted a second class of stock.

It is interesting to note, however, that the Commissioner apparently did not believe that he had a sound case in *Henderson, Gamman,* or *Lewis Building and Supplies, Inc.*, each of which he conceded on appeal. Thus, the amended regulations have not really been tested in a court of law. The subject matter also becomes complex when it is considered that the effect of the amended regulations is to follow the decision of the Tax Court in *Gamman,* where there were four conflicting opinions.

As previously noted, the Congressional purpose for Subchapter S of the Internal Revenue Code was to select the form of business organization desired without the necessity of taking into account major differences in tax consequences. Thus, it would appear that the legislators intended to permit a group of individuals to take advantage of limited liability (for example) inherent in the corporate form of doing business, and at the same time to be taxed as a partnership. The issue of debt versus equity capital, peculiar to corporations, therefore, serves only to defeat and complicate the basic premise upon which Subchapter S was enacted. Further, section 1374(c)(2)(B)\(^38\) allows the shareholder to include as the adjusted basis of his stock any indebtedness of the corporation to the shareholder. Thus, Congress must have recognized the existence of indebtedness of subchapter S corporations to their shareholders. It should also be recognized that small corporations are quite often faced with the necessity of borrowing money from their shareholders or third parties\(^39\) and thus will run the risk of being considered thinly capitalized. Consequently, the small businessman, for whom Subchapter S was enacted, is not motivated to make use of the statute.

The dual test that has now resulted creates substantial problems in tax planning because of the similarity between the nature of a debt obligation and a class of stock other than common stock. For example, if the instrument of the corporate debt to the shareholder lacks a provision for interest, this is a factor indicating that the purported debt is in substance a contribution to equity capital. On the other hand, if the instrument is, as in most debt obligations, interest bearing, this will indicate that the purported debt has preference as to dividend rights over the nominal stock, and the courts may disqualified the subchapter S corporation for having more than one class of stock. Similarly, if the purported loans are proportionate to the nominal stock ownership, this will be indicative that such

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39 See *Murphy Logging Co. v. United States,* 239 F. Supp. 794 (Ore. Dist. Ct. 1965), where the court held that corporate loans from a bank, but guaranteed by the shareholders, were in reality loans from the shareholders.
advances were contributions to capital. If the loans are disproportionate, as in most corporations, however, amended regulation 1.1371-1(g) indicates that such obligations will constitute a second class of stock. As another example, if the corporation provides the shareholder with security for his advances, this factor may be construed to indicate that a true indebtedness existed; but the conclusion may also be reached that the security is indicative of a second class of stock because of the resulting liquidation preference. While the writer recognizes that these problems are possible to resolve because these are not the only factors to be considered in reaching a conclusion upon this type of case, the fact remains that the problem seems to have become more complex as a result of the decisions by the Tax Court.

In *Gamman*, the majority opinion concluded that a second class of stock did not exist because when none of the terms of the notes had been enforced, the noteholders had not received any preferential treatment over the shareholders. The subchapter S corporation in that case incurred substantial recurring losses, and it would have been extremely difficult for the corporation to meet its obligations. If the corporate business had earned enough profits to repay the advances (as it had intended upon the formation of the corporation), as in *Catalina Homes, Inc.*, the decision of the Tax Court would logically have been that the purported debt was a second class of stock because of the preferential treatment afforded to the noteholders. The incomprehensible conclusion that loss corporations are eligible as subchapter S corporations and profitable corporations are vulnerable to the second class of stock attack is the end result.

It is also significant that the thin-capitalization doctrine, which is being applied to subchapter S corporations to determine whether advances by a shareholder are debt or equity, has been traditionally applied to prevent the avoidance of double tax by an ordinary corporation which pays out dividends in the guise of deductible interest and repayments of the purported debt. Since there is no double tax in a Subchapter S situation, it would logically appear that this doctrine should not be applicable.

Thus, a tax controversy of potentially extreme proportion has resulted in the area of subchapter S corporations. The trend toward controversy will develop as predicted by Judge Dawson in his concurring opinion in *Gamman*:

I think the second class of stock doctrine, as stated in the regu-

40 46 T.C. 1 (1966).
41 §§ P-H Tax Ct. Mem. 1491 (1964). See the last sentence on page 1497 where Judge Fay said: "Therefore, the fact that petitioner did not use these amounts to retire, in part, the purported loans from Spano and Blackshaw is a further indication that their advances represented permanent investments in petitioner in the nature of equity contributions." Thus, because the loans were not repaid, this was indicative that the advances were equity contributions, but if the advances had been repaid, the court would have had sound grounds for contending the existence of a second class of stock because of the preferential treatment given to these purported loans.
lations, is inconsistent with the intent of Congress and may produce grave inequities that were never originally contemplated.\footnote{Gamman, \textit{supra} note 40, at 9.}

With the formation of more small businesses in the future, the dilemma of Subchapter S would seem to be a matter upon which congressional action will become a necessity or the United States Supreme Court will have to set forth more specific guidelines.

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