

APPLICATION OF THE THIN INCORPORATION DOCTRINE TO THE SUBCHAPTER S ONE-CLASS-OF-STOCK REQUIREMENT

The Treasury's recent amendment of its regulation regarding the treatment of purported debt obligations as a second class of stock for purposes of Subchapter S election represents a more defensible interpretation of the statute. However, since the regulation calls for an application of the principles of the thin incorporation doctrine to an area in which they are seemingly irrelevant, many Subchapter S corporations may be subjected to excessive penalties. This comment explores the decisional authority preceding the amendment, and examines the propriety of analyzing the one-class-of-stock requirement in terms of thin incorporation precepts.

SUBCHAPTER S¹ was enacted in an attempt to eliminate the influence of the federal income tax in the selection of a form of business organization by according the owners of small businesses an opportunity to enjoy the advantages of corporate status without the burden of a tax at both the corporate and shareholder levels.² Consistent with its intent to limit the statute's benefits to small businesses, Congress inserted in the act several requirements for qualification, one of which was that an electing corporation may have only one class of stock.³

¹ INT. REV. CODE OF 1954, §§ 1371-78. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 14.01-10 (2d ed. 1966); Braverman, *Special Subchapter S Situations—Regulations Run Rampant*, 114 U. PA. L. REV. 680 (1966); Calkins, *How to Use Subchapter S and Section 1244 Without Running Into Trouble*, 15 W. RES. L. REV. 349 (1964); Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 VA. L. REV. 61 (1960); Crumbley, *Avoid Unintentional Disqualifications of Subchapter S Corporations*, 44 TAXES 374 (1966); Guardino, *Tax-Option Corporations*, 12 PRAC. LAW., May 1966, at 55; Lourie, *Subchapter S After Six Years of Operation: An Analysis of Its Advantages and Defects*, 22 J. TAXATION 166 (1965); Nagel, *The Tax-Option Corporation—Sections 1371-8 of the Internal Revenue Code*, 44 TAXES 364 (1966); Salkin, *What the Courts and the Commissioner Have Been Saying About Subchapter S*, 24 J. TAXATION 116 (1966); Schwartz, *New Subchapter S Law Passed: Relaxed Rules Require Reexamination of Election*, 24 J. TAXATION 370 (1966).

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

³ INT. REV. CODE OF 1954, § 1371 (a) (4). To be eligible to elect the tax status provided in Subchapter S, the business entity must be a domestic corporation with only one class of stock and ten or less shareholders. *Id.* § 1371 (a) (1). Furthermore, it must not be a member of an affiliated group of corporations as defined in INT. REV. CODE OF 1954, § 1371 (d). *Id.* § 1371 (a). All of its shareholders must be individuals or estates, *id.* § 1371 (a) (2), and it must not have a nonresident alien as a shareholder, *id.* § 1371 (a) (3); see B. BITTKER & J. EUSTICE, *supra* note 1, at § 14.02.

Subsequent to qualifying for the election under Subchapter S, the corporation must

The statute, however, does not specify the types of financial arrangements which constitute the prohibited second class of stock and which thus preclude or terminate a Subchapter S election.

To clarify the Subchapter S one-class-of-stock requirement, the Treasury in 1959 issued an interpretative regulation which stated that "if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."⁴ The effect of the regulation was to expose both the availability and validity of a Subchapter S election to the vagaries of the thin incorporation doctrine, a judicially-created theory by which shareholder loans have frequently been classified as equity capital in order to thwart tax avoidance.⁵ There is considerable uncertainty, however, as to the situations in which courts will apply the thin incorporation doctrine. The automatic classification of shareholder debt as the prohibited second class of stock under the 1959 regulation⁶ significantly increased the likelihood of an unintentional disqualification by an electing corporation.

Spurred by several judicial decisions which questioned the auto-

meet the two following year-by-year income requirements: (1) it must derive 20 percent of its gross receipts from sources within the United States, and (2) no more than 20 percent of its gross receipts can be in the form of passive investment income. The Internal Revenue Code states that these two conditions are requirements to avoid termination of a Subchapter S election rather than requirements for qualification. See INT. REV. CODE OF 1954, §§ 1372 (e) (4)-(5); Treas. Reg. § 1.1372-(b) (4) (1959); Treas. Reg. § 1.1372-4 (b) (5) (1965); B. BITTKER & J. EUSTICE, *supra* note 1, at § 14.03.

⁴Treas. Reg. § 1.1371-1 (g), T.D. 6432, 1960-1 CUM. BULL. 321.

⁵"The shareholders of a closely-held corporation often cast part of their investment in the form of 'debt' for tax rather than business reasons. Because the courts have upheld the government's refusal to accept the form of the instrument as controlling, there has been a vast amount of litigation over the proper classification of disputed instruments." B. BITTKER & J. EUSTICE, *supra* note 1, § 4.02 at 121. See generally *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957); B. BITTKER & J. EUSTICE, *supra* §§ 4.02-.06; S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 1173-1204 (1960); Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959).

⁶The 1959 regulation defined classes of stock thus: "A corporation having more than one class of stock does not qualify as a small business corporation If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. 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. *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) (1959) (emphasis added).

matic classification scheme of the 1959 regulation and one Tax Court decision⁷ which flatly held it invalid, the Treasury recently amended the regulation to read as follows:

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.⁸

An analysis of this modified juxtaposition of the one-class-of-stock requirement and the thin incorporation doctrine, in terms of the purpose of Subchapter S and the effect of an election under it, compels the conclusion that the amendment brings the regulation closer to a defensible interpretation of the statute; nevertheless, the general propriety of permitting an application of the thin incorporation doctrine to produce a Subchapter S disqualification is still questionable.

Cases considering the 1959 version of the regulation offer an historical, if not analytical, background against which to evaluate both the applicability of the thin incorporation doctrine to Subchapter S corporations and the recently amended regulation. The validity of the 1959 regulation was not considered at the court of appeals level, but two lower court cases did accept the Treasury's position that debt transformed into equity via the thin incorporation doctrine automatically created a second class of stock and thereby terminated a Subchapter S election. In *Catalina Homes, Incorporated*⁹ the Tax Court ruled that unsecured five percent loans without a fixed maturity date, for which no notes or other evidences of indebtedness were issued, and held by the shareholders in proportion

⁷ W. C. Gamman, 46 T.C. 1 (1966).

⁸ Treas. Reg. § 1.1371-1 (g) (1966).

⁹ 33 P-H Tax Ct. Mem. 1491 (1964).

to their stockholdings,¹⁰ created the disqualifying second class. Unfortunately, the court considered only those factors relating to the debt-equity question and did not analyze the more difficult question of whether this tainted debt constituted a second class of stock for purposes of Subchapter S. Accepting the Commissioner's classification of the debt obligations as stock, the court summarily concluded that it amounted to a second class of stock because it was preferred over the no-par common.¹¹

In *Henderson v. United States*,¹² a second case considering the relevancy of the thin incorporation doctrine to Subchapter S corporations, a federal district court also held that debt classified as equity created a second class of stock and disqualified the Subchapter S election. Since the loans, unsecured eight percent demand notes, were used to purchase essential operating equipment, were advanced in proportion to shareholdings, and were not strictly enforced, the court found that the funds advanced were in fact equity contributions. In its opinion, the district court did not discuss either *Catalina Homes* or the 1959 Treasury regulation, but, like the Tax Court, concluded summarily that classification of the debt as equity capital automatically precluded a Subchapter S election.¹³

¹⁰ There was some dispute as to whether the shareholders' loans were actually proportional to their stock holdings. The Commissioner alleged that they were proportional, adding to the holdings of the principal shareholders the stock held by members of their families. Without passing on the Commissioner's allegations, the court held that proportionality was not determinative on the debt-equity question and did not even raise the proportionality issue in considering the second class of stock question. *Id.* at 1499.

¹¹ The taxpayer did not specifically allege the invalidity of the regulation, but argued instead that the court should not use the thin incorporation doctrine to transform the corporation's debts into stock since there were no tax advantages to the Government in treating interest as dividends if a corporation were taxed under Subchapter S. The court accepted this proposition, but noted that the taxpayer had not demonstrated that other individual or corporate tax advantages did not motivate him, and that therefore his argument was insufficient. The court thus implied that if the taxpayer had considered all of the possible tax advantages in his own thin incorporation and had shown their inapplicability to his own Subchapter S election, he might have maintained the legitimacy of the corporation's debts and thus maintained its Subchapter S status. *Id.* at 1498.

¹² 245 F. Supp. 782 (M.D. Ala. 1965). For a criticism of the decision see 38 U. COLO. L. REV. 292 (1966).

¹³ The taxpayer appealed the decision to the Fifth Circuit. The Commissioner, however, on December 19, 1966, after submission of briefs and oral argument, reversed the effect of the district court's decision by agreeing to pay an administrative refund in return for the taxpayer's dismissal of the appeal. The Commissioner agreed to the refund because the loans in *Henderson* complied with the proportionality requirement in the new regulation which was to become effective December 28. See note 8 *supra* and

In contrast to these earlier cases, a subsequent Tax Court decision carefully distinguished the second-class-of-stock question from the debt-equity question and held that the equity created by the thin incorporation theory represented simply an additional capital contribution. In *W. C. Gamman*¹⁴ the majority concluded that nothing in the 1959 regulation or its legislative history indicated that the classification of debt as equity capital should automatically create a second class of stock; therefore, the court continued, the regulation was invalid as applied.¹⁵ Although it questioned the general applicability of the thin incorporation doctrine to Subchapter S corporations, the court limited its discussion to the proportional debt-equity arrangement in the case before it.¹⁶ Considering the Commissioner's second-class-of-stock argument apart from the regulation, the court suggested that the one-class-of-stock restriction was inserted in Subchapter S to minimize complexities that could arise from distributing corporate earnings to shareholders with differing rights and obligations.¹⁷ No distribution problem existed in *Gamman* because the debt obligations were held entirely by the stockholders and in proportion to their stock. Following the *Gamman* result, but without offering the same extensive discussion, the Tax Court in *Lewis Building & Supplies, Incorporated*¹⁸ again ruled that shareholder non-interest bearing demand notes were capital contributions. Although the ratios of the shareholders' debts to their equity holdings were not as closely proportional in *Lewis* as in *Gamman*,¹⁹

accompanying text; Letter From Edward W. Wadsworth, Clerk, Fifth Circuit Court of Appeals, to the *Duke Law Journal*, Jan. 30, 1967.

¹⁴ 46 T.C. 1 (1966).

¹⁵ *Id.* at 8.

¹⁶ *Id.* at 11.

¹⁷ *Id.* at 7. The *Gamman* court distinguished *Catalina Homes* and *Henderson* on the ground that the regulation was not challenged in those cases. However, it has been suggested that the court's willingness to look beyond the agreement to see that there was really no preference is what actually distinguished the case from *Catalina Homes*. Rewrite Bulletin No. 22-123, CCH 1966 STAND. FED. TAX REP. ¶ 8533.

¹⁸ 35 P-H Tax Ct. Mem. 949 (1966).

¹⁹ A pair of shareholders owning 700 shares advanced the corporation \$12,500 and another pair of shareholders owning 300 shares advanced \$6,000. *Id.* at 953. The Commissioner might have argued that this disproportion of equity to debt holdings created a relationship between the two groups as debt-holders that was different from their relationship as shareholders, thus creating a potential problem in the distribution of earnings once the debts were classified as stock. Such an argument would not be inconsistent with *Gamman* since the debt-equity ratios in that case were exact. See note 16 *supra*. See also *Seven Sixty Ranch Co. v. Kennedy*, 66-1 U.S. Tax Cas. 85,608 (D. Wyo. 1966).

the Commissioner, avoiding the argument that the rights of the shareholders were altered by their debt holdings, merely asserted the validity of the regulation. In rejecting the Commissioner's contentions, the court concluded that *Gamman* was indistinguishable.²⁰

The amended version of the regulation has been tailored to permit a Subchapter S election where, as in *Gamman*, shareholders hold debt obligations in amounts essentially proportional to their stockholdings.²¹ Since a proportional debt-equity arrangement constitutes the most widely used method of financing closely held corporations with shareholder-owned debt,²² the likelihood of unintentional disqualification has been decreased. Further, by retaining the general proposition that tainted shareholder debt will generally constitute a second class of stock, the regulation contemplates disqualification in those situations which actually present the allocation of income difficulties which the *Gamman* court regarded as the provocation for the one-class-of-stock requirement. At the same time, by providing

²⁰ Despite the persuasiveness of the *Gamman* opinion and the subsequent decisions following it, an argument in favor of upholding the 1959 regulation is not altogether without merit. A court might have accepted the classification of all disallowed debt as a second class of stock even without the specific authorization of the regulation. Since nominal debt usually differs in its terms from common stock, but frequently resembles cumulative, non-participating, redeemable preferred stock, it is arguable that tainted shareholder debt should be automatically treated as preferred stock. See W. C. Gamman, 46 T.C. 1, 13-14 (1966) (dissenting opinion). The specific authorization of the 1959 regulation, with the presumption in favor of its validity, simply adds additional weight to such a classification. The regulation is arguably a reasonable exercise of the Commissioner's authority since the statute, despite a reference to shareholder loans, INT. REV. CODE OF 1954, §§ 1374 (c) (2), 1376, says nothing about excessive shareholder debt. Furthermore, Congress subsequently amended the statute, e.g., Revenue Act of 1962 § 23, 76 Stat. 960; Revenue Act of 1964 § 233, 78 Stat. 19, without nullifying the Treasury's interpretation, an act frequently interpreted to indicate congressional approval. See *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 114-15 (1939).

²¹ See text accompanying note 16 *supra*.

²² See RIA, TAX COORDINATOR ¶ D-1505, at 105 (1967). In a closely held corporation the issuance of debt obligations for shareholder advances has several tax advantages. First, interest paid on the debt obligations are deductible by the corporation. INT. REV. CODE OF 1954, § 163. If the distributions were in the form of dividends the corporation would lose its deduction but the shareholder would be slightly benefited since he could deduct the first one hundred dollars. *Id.* § 116. Secondly, if the business prospers the corporation can retire its debt obligations, thus removing earnings from the corporation to the shareholder who will not be taxed since they are a return of his investment and not a dividend. I F. O'NEAL, CLOSE CORPORATIONS § 2.09, at 55 (1958). Thirdly, by accumulating reserves to retire its debt obligations, the corporation may avoid the surtax on accumulated earnings. *Id.* Finally, if the corporation fails the shareholder-creditor will receive a partial bad debt deduction and not just a capital loss. INT. REV. CODE OF 1954, § 166. But see note 25 *infra* and accompanying text.

for a "new determination" rather than an automatic disqualification when the proportionality of the debt-equity structure is disturbed, the amended regulation offers some hope that other financial arrangements which do not pose distribution difficulties may also be excepted.

Because the defect in the 1959 regulation which prompted the result in *Gamman* may be of a more fundamental nature than the Treasury has contemplated, the simple expedient of engrafting a single exception upon its central proposition may not be curative. The principal weakness in the amended regulation is the continued use of definitions of "stock" and "debt" borrowed from the thin incorporation doctrine, appropriate only in the context of preventing tax avoidance. Furthermore, even if application of the thin incorporation doctrine should be necessary to prevent the abuses of shareholder-debt financing, the statutory purposes of Subchapter S and the one-class-of-stock requirement give no justification for penalizing an electing corporation with termination of its election in addition to the disallowance of its excessive shareholder debt. Therefore, the amended regulation, by permitting disqualification for excessive non-proportional shareholder debt, would appear unnecessarily restrictive and an inaccurate interpretation of the statute.

Application of the thin incorporation doctrine in the Subchapter S context is necessary only to prevent tax abuses made possible because corporate distributions to holders of debt are taxed differently than distributions to holders of equity.²³ The theory, as applied by the courts, will prohibit an interest deduction by a corporation in situations in which nominal interest payments to equity holders actually represent a distribution of earnings. Similarly precluded by application of the doctrine is withdrawal of earnings as repayments of principal rather than as dividends—a scheme intended to avoid taxation of these amounts at the shareholder level.²⁴ In their efforts to distinguish the thinly capitalized corporation from the

²³ See note 5 *supra* and accompanying text; note 22 *supra*.

²⁴ Another advantage to a "thin" capital structure is that the necessity for repaying the loan provides a defense against the assessment of an accumulated earnings tax. Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959); Garver, *Closely Held Businesses, Tax Factors Affecting Debt-Equity Financing For a New Small Corporation*, 17 W. RES. L. REV. 773, 777 (1966). However, any advantage to thin incorporation exists only if profits exist in the corporation, since any cash distribution by a deficit corporation is treated as a return of capital, not a dividend. Treas. Reg. § 1.316-1(a)(2) (1955).

legitimately financed corporation the courts have examined such factors as the proportionality of shareholder debt to stockholdings, the actual ratio of corporate debt to stated equity, whether the proceeds have been utilized to purchase "essential" assets, and whether the parties had a genuine intent to create a debtor-creditor relationship.²⁵ Of particular interest to courts evaluating the legitimacy of a shareholder loan are provisions for payment of interest. If interest will be paid even in periods of earnings insufficient to justify dividend distribution, some courts consider this significant in preventing a debt to equity transformation.²⁶ Unfortunately, since the weight to be given a combination of the above factors by a particular court cannot be predicted, taxpayers are unable to determine the precise extent to which their corporations may be safely financed with shareholder debt. Due to the disparity in consequence, this uncertainty, of course, constitutes a greater hazard to the Subchapter S corporation than to a non-electing corporation. Positing that the only essential difference between two hypothetical corporations is that one has elected Subchapter S treatment, the non-electing corporation and its shareholders have little to lose by capitalizing heavily with shareholder-owned debt, since the tax status of this arrangement may be easily tested by a claim for an interest deduction. If the debt is disallowed and transformed under the thin incorporation doctrine into equity, the owners of the business are in no worse position than if they had capitalized the corporation entirely with stock. On the other hand, the Subchapter S corporation which is deemed to have excessive non-proportional shareholder debt would not only have the debts disallowed but also would find its optional tax treatment terminated. Since a post-termination distribution of previously taxed but undistributed earnings will be taxed

²⁵ B. BITTNER & J. EUSTICE, *supra* note 1, at 124-27. The writer of one exhaustive study suggests that the courts originally looked at the intent of the parties, gradually turned to a strict ratio test, and now have returned to the "intent-of-the-parties" test. Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959). Even when using the supposedly subjective "intent" standard, however, the courts have often used some of the more objective criteria to decide whether this intent existed. Aarons, *Debt v. Equity: Special Hazards in Setting Up the Corporate Capital Structure*, 23 J. TAXATION 194 (1965); see *Montclair, Inc. v. Commissioner*, 318 F.2d 38 (5th Cir. 1963); *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962); Gerver, *De-emphasis of Debt-Equity Test for Thin Corporations Requires New Defense Tactics*, 23 J. TAXATION 28 (1965). A summary of the tests presently being used by the courts can be found in RIA, TAX COORDINATOR ¶¶ K-5100 to K-5120.

²⁶ See, e.g., *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935).

again to the shareholder to the extent of any accumulated earnings and profits, such a termination may constitute a severe penalty.²⁷ Thus, while it is generally advisable for an electing corporation to distribute income currently, such a procedure presents practical difficulties. For instance, due to the inability of some corporations to accurately estimate income until the latter half of the tax year, funds to make current distributions in an amount equal to taxable income may be lacking. Further, a corporation may require all or part of the income to finance future business activities,²⁸ thereby rendering total current distribution undesirable.

The taxing scheme employed in Subchapter S suggests, first, that its framers did not intend that the thin incorporation doctrine would effect such a severe consequence as the termination of a Subchapter S election, and, secondly, that application of the thin incorporation doctrine, as a practical matter, would be unnecessary in most Subchapter S situations. By providing taxpayers an opportunity to select a form of organization without regard to tax considerations, Congress in essence legalized the principal objective of thin incorporation—that is, the avoidance of a tax at both the corporate and shareholder levels. This end is accomplished under Subchapter S by eliminating the tax on a qualified electing corporation. No advantage accrues to the shareholder of an electing corporation in withdrawing earnings as a return of principal, since the earnings are taxed to the shareholders at individual rates irrespective of withdrawal.²⁹ Similarly, there can be no advantage to the shareholder who claims a deduction on the corporate return for interest

²⁷ Treas. Reg. § 1.1375-4(b) (1959). A major problem peculiar to operating under Subchapter S relates to the difficulties in withdrawing previously taxed income, *i.e.*, income of an electing corporation that is not distributed during the taxable year and that is, therefore, taxed to the shareholders at the end of the year as a constructive dividend. This P.T.I. (previously taxed income) cannot be withdrawn tax-free in a later year unless *all* current earnings and profits for such later year are first distributed. Treas. Reg. § 1.316-2(a) (1955). Moreover, after the election is terminated the special rule of permitting the tax-free distribution of P.T.I. is no longer operative; thus, general corporate rules apply and distributions by the corporation of P.T.I. after termination are taxable as dividends to the extent of both current and accumulated earnings and profits. Note, "Locked-In Earnings"—How Serious a Problem under Subchapter S?, 49 VA. L. REV. 1516, 1522-23 (1963) (detailed analysis with examples).

²⁸ To escape the problem of distributing all of its income currently, an electing corporation will usually distribute its taxable income to the shareholders, who then lend it back to the corporation. However, this again raises the problem that these loans will be classified as risk capital and disallowed via the thin incorporation doctrine.

²⁹ Garver, *supra* note 24, at 779.

on shareholder-owned debt, because these amounts if received by the shareholder-creditor would be taxed to him as interest or, if not received, as a share of the undistributed income of the corporation under section 1373.³⁰ Although there still exist situations in which a "thin" capital structure and the Subchapter S form might be combined in an unauthorized tax avoidance attempt,³¹ application of the thin incorporation doctrine could be reasonably limited to situations in which attempts at tax avoidance in fact existed. Furthermore, even in these instances, the effect of the doctrine should be merely to prevent specific abuses and not to disqualify the entire election.³²

An examination of the statutory purpose behind the one-class-of-stock requirement also tends to establish that classification of shareholder loans as equity should not create a second class of stock. The one-class-of-stock requirement is not aimed at the prevention of tax avoidance, but rather represents a congressional attempt to avoid complexities in the allocation of earnings to shareholders with differ-

³⁰ INT. REV. CODE OF 1954, §1373. Also, there would be no accumulated earnings. Garver, *supra* note 24, at 779.

³¹ Application of the thin incorporation doctrine might still be necessary to prevent tax abuses if the shareholders attempted to take advantage of the "thin" structure either before the Subchapter S election or after its termination. Also, there are advantages to a thinly capitalized Subchapter S corporation even during a year in which the election is in effect if the corporation desires to distribute accumulated earnings. If accumulated before the shareholders elected Subchapter S, these earnings would have been taxed at the corporate level, but not at the shareholder level, and their distribution to the shareholders as a return of principal would constitute the same abuse as if they had been distributed by a normal corporation. Although application of the thin incorporation doctrine would seem appropriate in this situation, the disallowed debt should be treated as an additional contribution to capital rather than as a disqualifying second class of stock.

In other situations the combination of Subchapter S and a large shareholder debt might be beneficial to the stockholder. It has been suggested, for example, that the interplay of §1232, which allows capital gains treatment upon the retirement of corporate obligations, and §1376, which permits the shareholder to deduct his proportionate amount of the corporation's net operating loss, might enable a high-bracket taxpayer to deduct a corporate loss from his ordinary income, reduce the basis of his corporate debt, and then have the gain on the retirement of the debt treated as capital gain rather than ordinary income. Rewrite Bulletin, *supra* note 17. However, this advantage seems to be offset by the possibility that the corporation's losses will exceed the combined bases of the stockholders' debt and stock, with the result that this excess would never be deductible either as an ordinary loss or as a capital loss. See INT. REV. CODE OF 1954, §1374(c)(2); W. C. Gamman, 46 T.C. 1, 11 (1966). See generally B. BITTKER & J. EUSTICE, *supra* note 1, at 729-31.

³² Application of the thin incorporation doctrine to Subchapter S corporations has been questioned in other sources. See Aarons, *supra* note 25, at 194; Braverman, *supra* note 1, at 684.

ing rights and obligations.³³ While this consideration is not extensively discussed in the legislative history of the 1958 Act, a report of the Senate Finance Committee,³⁴ which drafted a similar provision in 1954, more clearly reveals this motivation. If dividends in excess of current earnings were paid to preferred shareholders, these persons would receive amounts which had been previously taxed to both the common and preferred shareholders but left in the corporation, since the earnings of a Subchapter S corporation are taxed to the shareholders without regard to actual distributions. In order to keep the common stockholders from bearing a disproportionate tax burden, a deduction would have to be accorded to the owners of common stock. Allocation of such a deduction would be difficult, especially if any of the common shares had been transferred during the interval between the original taxation of the earnings and the distribution to the preferred shareholders. The one-class-of-stock requirement thus represents a congressional decision to avoid such difficulties rather than draft intricate and perhaps arbitrary rules for their solution.

The relevant inquiry must be whether classification of shareholder debt as stock creates the distribution difficulties sought to be avoided by Congress. It might appear that the same difficulties are created in allocation of the tax burden, since the thin incorporation doctrine transforms the debt into a class of stock with rights demonstrably different than those of the common stock. However, in the typical case of a thinly capitalized close corporation, where the debt is held solely by shareholders essentially in proportion to their stock holdings, a distribution problem cannot arise, since any preference for the shareholder as creditor is merely a preference over himself as shareholder.³⁵ Therefore, the distinction in the amended regulation

³³ See *A. & N. Furniture & Appliance Co. v. United States*, P-H 1967 FED. TAX SERV. (19 Am. Fed. Tax R.2d 1485) ¶ 67-607 (S.D. Ohio Apr. 24, 1967).

³⁴ S. REP. NO. 1622, 83d Cong., 2d Sess. 453-54 (1954).

³⁵ See note 17 *supra* and accompanying text. In *A. & N. Furniture & Appliance Co. v. United States*, P-H 1967 FED. TAX SERV. (19 Am. Fed. Tax R.2d 1485) ¶ 67-607 (S.D. Ohio Apr. 24, 1967), an electing corporation qualified despite the existence of a voting trust which the Government alleged created a second class of stock. The court concluded that since the voting trust did not increase the size of the corporation or complicate corporate distributions, the election was valid. The court articulated the following reason for the one-class-of-stock requirement: "It was thought that the complexity involved in passing the earnings of a corporation through to its shareholders, where the stock of the corporation is held by a widely diversified group of shareholders,

between proportional and non-proportional debt-equity arrangements is defensible as an attempt to permit arrangements in which the preferences are illusory and to condemn schemes in which distribution difficulties would arise.

The proportionality test, however, creates a number of difficulties for the taxpayer. First, a question is raised by the doctrine enunciated in *Murphy Logging Company v. United States*:³⁶ shareholder-guaranteed bank loans to a thinly capitalized corporation are to be treated as loans from the shareholders individually under the thin incorporation doctrine. If courts were to accept this principle when considering a Subchapter S corporation's satisfaction of the one-class-of-stock requirement, the danger that shareholder-guaranteed debts will be classified as a second class of stock is increased. The shareholders, though arranging direct loans in proportion to their shareholdings, may not be so careful to prorate their guarantees of outside loans.³⁷ Secondly, the distinction between proportional and non-proportional debt-holdings creates a dilemma for electing corporations when coupled with the present uncertainty of the thin incorporation tests. Since the proportionality of shareholder debt to stockholdings is one factor leading the courts to find that debt is actually equity, making the loans proportional as the amended regulation requires would actually increase the likelihood that a court would initially classify the debt as stock.³⁸ Thirdly, loans, unlike equity shares, generally possess maturity or redemption characteristics which may lead to alteration of originally proportional debt-equity holdings. Thus, if shareholder A's loans are repaid prior to

created accounting complications which were too great a burden for the government to bear, and thus the restrictions as to one class of stock." *Id.* at 1489.

³⁶ 239 F. Supp. 794 (D. Ore. 1965). *Contra*, *Fors Farms, Inc. v. United States*, 17 Am. Fed. Tax R.2d 222 (W.D. Wash. 1965).

³⁷ In a case actually involving a Subchapter S corporation and shareholder-guaranteed bankloans, however, the taxpayer argued that the shareholder-guaranteed loans should be treated as shareholder debt in order to increase the adjusted basis of his own corporate debt and thus permit a larger net operating loss deduction. *William H. Perry*, 47 T.C. 159 (1966); *see* INT. REV. CODE OF 1954, § 1374 (c) (2). The court rejected this contention and held that his secondary liability was not enough to constitute actual debt. 47 T.C. at 164. The case did not raise any second-class-of-stock questions, but the Commissioner's position suggests that *Murphy Logging Co.* may not be applied to Subchapter S corporations. RIA, TAX COORDINATOR ¶ K-5118.1, at 32,159 (1967).

³⁸ Although the shareholders of a Subchapter S corporation would not usually have any incentive for creating a large amount of shareholder debt, a thin incorporation would be of advantage if the shareholders switched back and forth between the Subchapter S and the normal corporate form. *See* note 31 *supra* and accompanying text.

the satisfaction of obligations held by shareholder *B*, the proportionality required by the regulation may be destroyed.³⁹ While original incorporators can now anticipate this difficulty, currently electing entities may be precluded from continued participation in Subchapter S provisions. Finally, proportionality is not an unambiguous concept. If one shareholder is unable to supply his share of the capital, he may borrow from another shareholder and in turn lend to the corporation—a transaction which the Commissioner might treat as a contribution from the original supplier of the capital.

Taxpayer difficulties in the treatment of shareholder debt as a second class of stock arose because the Treasury transferred the labels of the thin incorporation doctrine to an area of the law in which they simply were not relevant. The classification of debt as stock to prevent possible abuses in the distribution of corporate earnings should not necessitate the transformation of that debt for all subsequent judicial definitions of the word "stock."⁴⁰ The thin incorporation doctrine is not a statutory requirement, but a common law fiction whose terms are applicable only in the context of preventing specific attempts at tax avoidance. The Treasury's failure to recognize the limits of the doctrine accounts for the excessive penalty to which any Subchapter S corporation might now be subjected.

The ultimate source of the problem created by the regulation, however, is not merely the similarity of terms between the thin incorporation doctrine and the requirements of Subchapter S, but rather Congress' failure to close the loopholes existing in the statutes. Both the different treatment of corporate distributions to shareholders and creditors and the optional feature of Subchapter S, allowing the taxpayer to switch back and forth between the normal and the Subchapter S corporation, provide a basic framework within which the taxpayer can manipulate his business structure to achieve unintended tax advantages. Until one or both of these large areas is restricted, problems in the taxation of thinly incorporated Subchapter S corporations will probably continue.

³⁹ See RIA, TAX COORDINATOR ¶ D-1505, at 18,064 (1967).

⁴⁰ See *Campbell v. Carter Foundation Prod. Co.*, 322 F.2d 827 (5th Cir. 1963). The court held that installment notes given by a corporation to its sole shareholder were "debt" for the purposes of interest deductions by the corporation, but were "equity" for the purposes of establishing a substituted basis under § 351.