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The Requirement that a Subchapter S Corporation May Have Only One Class of Stock

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THE REQUIREMENT THAT A SUBCHAPTER S CORPORATION MAY HAVE ONLY ONE CLASS OF STOCK

Editor's Note: On December 27, 1966, during the process of publication, Reg. 1.1371-1(g) was amended, virtually adopting the Tax Court's view in the Gamman case. Some of the author's conclusions should be considered in light of this development.

By JERE D. MCGAFFEY*

Small business corporations meeting the requirements of Subchapter S of the Internal Revenue Code have become an increasingly popular form of business organization.[1] A Subchapter S corporation is exempt from corporate tax, but its shareholders are taxed on its earnings whether distributed or not. The result of this specialized tax treatment is similar to the tax imposed upon a business operating in partnership form, although the technique utilized in determining the tax is different.

Subchapter S was enacted to make it possible for many businesses to choose the type of legal organization best suited to their needs with a minimum of tax consideration.[2] This freedom of choice of legal organization was intended to be limited to businesses of a relatively small size, although no direct limitation was placed on the net worth or sales of such corporations.[3] The enactment of Subchapter S represented a legislative recognition that a single tax on corporate earnings at the individual level, at the time the earnings were earned by the corporation, would be an appropriate method of taxation for certain types of corporations.[4]

Only corporations meeting certain requirements are eligible to elect Subchapter S treatment.[5] All of these requirements must be carefully analyzed by an electing corporation in view of the substantial unforeseen tax liabilities which may be imposed if the corporation is held not to qualify. There is no tax imposed upon a corporation electing under Subchapter S,[6] as the shareholders are taxed on the entire earnings whether distributed or not.[7] Normally, the entire earnings will be distributed. The shareholder's normal desires to have cash for personal purposes and to pay taxes on the earnings are supplemented by the fact

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1 The number of corporations using the election has increased from 72,000 in 1959 to 141,000 in 1963. Tax Coordinator Bi-Weekly Alert, Vol. 12, No. 19, p. 2 (1966).

2 S. REP. No. 1983, 85th Cong., 2nd Sess. 1958-3 CUM. BULL. 1008.

3 A limit was rather placed on the number of shareholders. INT. REV. CODE OF 1954 §1371(a)(1). Compare INT. REV. CODE OF 1954, §1244.

4 For an analysis of the reasons for a double tax on corporate income see McGaffey, The Rationale and Requirements of Section 337, 40 TAXES 681 (1962).

5 INT. REV. CODE OF 1954 §1371.

6 INT. REV. CODE OF 1954 §1372(b).

7 INT. REV. CODE OF 1954 §1373.

that should he transfer the stock, a distribution of those earnings at a later date may subject his transferee to a second tax.[8] Since a closely held corporation not electing Subchapter S has strong tax motives not to make any distributions, a corporation which knew it was not under Subchapter S would normally have a substantially different dividend policy than a corporation which considered itself qualified under Subchapter S. A corporation which is found to have lost its Subchapter S status upon audit by the Internal Revenue Service will face an assessment for corporate income tax for prior years. If the corporation has followed the practice of distributing its entire earnings, it may have a substantial cash problem, since the dividends paid the shareholders will normally be far in excess of what would have been paid the shareholders if this liability had been known.[9] The unforeseen and retroactive nature of such liability makes it particularly harsh.

One of the requirements a corporation must satisfy to qualify for Subchapter S treatment is that the corporation have only one class of stock.[10] This requirement is deceptive in its simplicity. The Internal Revenue Service has ruled that the mere labeling of rights embodying a legal relationship will not be controlling.[11]

I. The Reasons for the Requirement of One Class of Stock

The reasons for this requirement are important—to the practitioner that he may be aided in properly interpreting the requirement's boundaries, and to the legislator that he may determine the requirement's necessity.

Although it is clear that Congress intended Subchapter S treatment to be available only to relatively closely held and presumably small corporations,[12] there is no reason to believe that the restriction that a small business corporation have only one class of stock was intended to be related to a restriction on the size of the corporations qualifying for Subchapter S treatment. In fact, closely held corporations often will have more than one class of stock because of differing family interests and problems of control, while large publicly held corporations often will have only one class of stock.[13]

It is also unlikely that this requirement was imposed in order to prevent any type of tax avoidance through the utilization of more than one class of stock in a Subchapter S corporation. There might have been

[8] Treas. Reg. §1.1375-4(e) (1959).

[9] If the corporation had $25,000 of income and was not a Subchapter S corporation, it would have corporate taxes of $5,500 leaving $19,500. The same corporation believing it was under Subchapter S may have distributed as dividends the entire $25,000. In such a situation the shareholders may be entitled to a refund, if the corporation did not have prior earnings and profits, as the current addition to earnings and profits would be only $19,500.

[10] Int. Rev. Code of 1954 §1371(a)(4).

[11] Rev. Rul. 309, 1964-2 Cum. Bull. 333; Rev. Rul. 226, 1963-2 Cum. Bull. 341.

[12] S. Rep. No. 1983, 85th Cong., 2nd Sess. 1958-3 Cum. Bull. 1008.

[13] It may even be considered more desirable for a publicly held corporation not to have several classes of stock.

concern that some family partnership problems would have occurred in the event that Subchapter S treatment was available to a corporation with more than one class of stock. All the common stock might be owned by the father who was active in the business with all the preferred stock which shared in earnings being owned by his children. This could result in what might be thought to be a distortion of the allocation of taxable income. However, the Commissioner is given an adequate tool to deal with this problem in his power to apportion income between members of a shareholder's family as to reflect the value of services rendered to the corporation by such shareholders.[14] If the earnings are not due to the rendering of services but represent a return on capital, it would be appropriate that they be allocated to whoever had provided the capital even though that capital may have been given to such person.

There is also the possibility of the reverse concern; that in a business where capital was the main income producing factor, the father might contribute a large amount of the capital for preferred stock and the children a small amount for the common. It might be thought that a disproportionate share of the earnings would be attributed to the children who would be in a lower tax bracket. However, they would be the ones entitled to such earnings by means of distribution or by means of growth on the equity value of the stocks. A partnership, by agreement, could provide similar rights. Such a capital structure may be an advantageous estate planning device to transfer the future appreciation to the children, but this could be accomplished with a nonelecting corporation. If there was concern that the preferred might bear an unreasonably low dividend rate (and this could not be attached by other means), a special provision for allocation might be used as in the services area. However, if the common stock was being given to the children, the relative rights of the preferred and common would be considered in valuing the common stock for gift tax purposes. Although this theory is a possible explanation of the one class of stock requirement, it seems unlikely unless support were to be found in the legislative history.

The congressional committee reports in 1958, the year Subchapter S was enacted, do not mention the reason for requiring small business corporations to have only one class of stock.[15] In 1954 the Senate advanced the predecessor provisions of Subchapter S which would have taxed such corporations as partnerships. Although the treatment then proposed was somewhat different from the ultimate provisions contained in Subchapter S, the 1954 proposed legislation did contain the requirement that the corporation have only one class of stock. The com-

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[14] INT. REV. CODE OF 1954 §1375(c).
[15] S. REP. No. 1983 85th Cong., 2nd Sess. 1958-3 CUM. BULL. 1008.

mittee report indicates that this was to prevent the complexities which would result from having to allocate earnings among several classes of stock.[16] In particular, the committee was concerned with the administrative problem created by the payment of dividends on preferred stock in excess of the current year's earnings.[17] The committee reports in 1964 when some provisions of Subchapter S were amended, lend further support to the theory that the reason for the requirement is administrative ease.[18] If this is the reason, rather than one founded upon tax equity or economic policy, the requirement should not be unnecessarily expanded beyond the area dealing with the technical problem of allocating earnings. Therefore, in the determination of what constitutes a separate class of stock, the effect differing rights may have upon the allocation of earnings should be the decisive factor. Thus, for the purpose of qualifying under Subchapter S,[19] differing rights unrelated to allocation of the corporation's earnings should not be considered to give rise to a second class of stock.

The problems of allocating earnings, had more than one class of stock been permissible, should be further analyzed to determine the extent of the administrative problem. In the case of a class of stock which has a preference as to dividends and as to liquidation rights, there would be no problem in allocating earnings in the event the earnings were sufficient to cover the preferred dividends each year. Whether or not the preferred dividend was paid, the preferred stockholder could be taxed on the amount of the dividend which he would receive either that year or in some later year, and the excess earnings would be taxed to the holders of the common.

The Senate Finance Committee report raised the problem of a distribution to preferred stockholders of dividends in excess of current earnings which represented earnings previously taxed to common stockholders.[20] This problem can best be explained by example. Assume that in the year 1964, the corporation has $1,000 of income and distributes the required dividend to its preferred stockholders of $500 and does not distribute the remaining $500. In the year 1965, it has no earnings and distributes the $500 retained to its preferred stockholders in satisfaction of their dividends. In the year 1964 the preferred stockholders would be taxed on the $500 of income distributed to them, and the common stockholders would be taxed on the undistributed taxable income as being $500 of dividend income. However, in the year 1965, the preferred stockholders would not be taxed on the $500 of

[16] S. REP. No. 1622, 83rd Cong., 2nd Sess. 119, 453 (1954).
[17] *Ibid.*
[18] S. REP. No. 830, 88th Cong., 2nd Sess. 146 (1964).
[19] However, the legislative history does suggest that differing voting rights would constitute a second class of stock. S. REP. No. 1622, 83rd Cong., 2nd Sess. (1954).
[20] S. REP. No. 1622, 83rd Cong., 2nd Sess. 453 (1954).

income when it was distributed to them, unless the corporation had current earnings and profits to that extent or there were accumulated earnings and profits.[21] As the Senate Finance Committee report indicates, this causes a certain amount of inequity.[22] The preferred stockholders should be taxed on this distribution and the common stockholders, which now in effect have lost their interest in the undistributed income, should obtain some tax benefit in all fairness.

The common stockholder's remedy in this situation, as in the situation where there is both preferred and common stock, would be to cause all income to be distributed out to the shareholders. It would seem quite inadvisable from a tax point of view to not distribute out all of a Subchapter S corporation's earnings.[23] An additional legislative remedy to the problem of the preferred and common stockholders would be to give the common stockholder a loss in 1965 for the $500 which he paid tax on and which is now being distributed to the preferred stockholder. This would be equitable since the $500 excess retained earnings which was previously available to the common stockholder would be transferred to the preferred stockholder because of the lack of any income in 1965. In order to avoid any possible manipulation, the right to the loss could be personal just as the right to previously taxed income is under the present provisions. Only the stockholder who had paid the tax in 1964 could obtain the benefit of the loss in 1965. The stockholder's tax rate in 1965 might be different than his rate in 1964 but that problem is present under the current rules on previously taxed income. This proposed rule should also apply in the event no distribution is made in 1965. In effect, the $500 is still being transferred from the common shareholder to the preferred shareholder. The preferred shareholder should be taxed on the amount in 1965, and the common shareholder should be given the benefit of the loss thereof. This proposed rule also would assume that any right to unpaid dividends would affect liquidation value, since otherwise the preferred stockholder would be inequitably treated from a nontax point of view. In the event that the stock was noncumulative, there would not be a problem. If a dividend was not paid in that year, there would be no transfer of earnings from the common to the preferred stockholder.

An even more difficult problem of allocating earnings arises in the case of losses where there is more than one class of stock. Presumably in the preferred and common stock case, the first loss should be suffered

[21] The $500 constructive dividend to the common stockholders reduces earnings and profits. INT. REV. CODE OF 1954 §1377(a). Thus the corporation would have no accumulated earnings and profits unless they had been accumulated prior to 1964 or earnings and profits exceed taxable income.

[22] S. REP. No. 1622, 83rd Cong. 2nd Sess. 453 (1954).

[23] If the corporation has accumulated earnings and profits, it may not be possible to distribute them tax free at a later date because of the limitations on the previously taxed income provisions. See Treas. Reg. §1.1375-4(e) (1959).

by the common stockholders, but this would be a question of fact. It would be very difficult to determine at what point the preferred stockholders also suffer some losses. Perhaps, there could be a presumption that the first losses would be against the common stockholders to the extent of their capital accounts and that once the losses exceeded these amounts, the loss would then be deductible by the preferred stockholders. This would have some analogy to the present rules concerning the basis of a shareholders stock and indebtedness.[24]

If such a rule were adopted and common stock was sold, the shareholder might not have enough basis to sustain the loss and yet the full amount of the capital account might not have been consumed. Assume a preferred stock account of $40,000 and a common stock account of $60,000. If in 1964 there was a $20,000 loss, it would be charged against the common stockholders. If the common stock was then sold for $25,000 and the corporation in 1965 sustained a $30,000 loss, it would still be allocable against the common stock account which would have $40,000 still remaining in it—yet the shareholder holding the common stock could only utilize $25,000 of the loss.[25] Such a result, however, would not be as detrimental to the taxpayer as prohibiting a second class of stock.

Although it appears that for normal situations Subchapter S rules could be devised to allow more than one class of stock, there can be no doubt that Subchapter S would be that much more complicated and that Congress can well deem that the disadvantages caused by such complexities would outweigh the advantages. It must be noted particularly in this connection that when the provision was first suggested in 1954, there was a requirement that each stockholder be active in the business.[26] Thus the importance of having a preferred stock was not as great as the more lenient provisions now contained in Subchapter S.

II. Different Classes of Stock Pursuant to the State's Corporate Law

In view of the statutory provision and particularly the regulations issued thereunder, it would seem quite inadvisable to attempt to have outstanding shares of stock, which a state's corporate law would treat as different classes of stock. However, the regulations do make clear that it is only the outstanding stock that is considered and that merely having authorized stock or even treasury stock which is of a different class will not void the Subchapter S election.[27] It has been suggested that if the only difference is par value or no par value, there are not two

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[24] Int. Rev. Code of 1954 §1376(b).
[25] The remaining loss, however, was recognized on the sale of the stock.
[26] S. Rep. No. 1622, 83rd Cong. 2nd Sess. 453 (1954).
[27] Treas. Reg. §1.1371-1(g) (1959).

classes of stock.[28] In addition the Service has ruled that special stock required by the Federal Housing Administration under certain of its regulations would not be deemed a separate class of stock.[29] Whether this last position would be taken by a court in the absence of a favorable ruling seems questionable, and it would seem to be a doubtful precedent to rely on in other situations. However, this ruling does indicate, to an extent, a reasonable attitude in looking at the situation in terms of the rationale behind the rule. The various factors which might be differentiated under the corporate law and which might result in separate classes of stock thereunder, should be evaluated to determine whether or not these should constitute separate classes of stock under the rationale of the Subchapter S rule.

A. *Varied Voting Rights.* The regulations are clear that a class of stock which has different powers of control or different voting rights will be considered a different class of stock.[30] Furthermore, the 1954 legislative history would tend to support such a position since it does mention voting rights.[31] The Tax Court has held that a corporation had more than one class of stock when the outstanding stock was divided into four classes, each class having the power to elect one director, all other rights depending upon the number of shares held.[31a] The purpose of this capital structure was to allow each of the four shareholders to elect one director, even though their other interests in the corporation differed. Nevertheless, if the only difference is voting rights, it is difficult to see the justification for not allowing such a corporation to be taxed as a Subchapter S corporation. If the only justification for such a rule is the problem of allocating profits, the rule should have no application to situations in which the only difference is voting rights which have nothing to do with allocation of profits. Furthermore, it should be pointed out that voting rights may be particularly insignificant in a small corporation. Certainly, the question of effective voting power does not seem to be a necessary requirement under the Code. In the case of a corporation in which one stockholder has more than two-thirds of the voting stock, whether the remaining stock is voting or not has little if any effect upon the operations of the corporation. Furthermore, in the normal small corporation, the question of whether or not this minority has voting power may be much more a psychological matter with the majority stockholders rather than a question of the minority's economic significance.

A possible justification for the result that varied voting rights deny a corporation Subchapter S treatment would be by analogy to the provi-

[28] Caplin, Subchapter S and its Effect on the Capitalization of Corporations, 13 VAND. L. REV. 185, 190 (1959).
[29] Rev. Rul. 309, 1964-2 CUM. BULL. 333.
[30] Treas. Reg. §1.1371-1(g) (1959).
[31] S. REP. No. 1622, 83rd Cong. 2nd Sess. 453 (1954).
[31a] Pollack, 47 T.C. No. 9 (Oct. 28, 1966).

sions for the taxation of trusts. A loophole might be created if the dominant shareholder wanted to keep complete control of the corporation but transferred part of its stock to his children. By retaining control the stockholder can determine whether the corporation would pay out dividends. If such a structure had been created by means of trust rather than a corporation, the person in control would be subject to tax.[32] This seems to be an extreme stretch of the normal rules, particularly when Subchapter S corporations cannot be merely incorporated pocketbooks[33] and non-Subchapter S corporations can achieve this same result. Furthermore, the same result is reached if the controlling stockholder has over 50 per cent of the stock.

Another argument justifying denial on this account might be that if the shareholder has no vote, he has no power to determine whether or not a dividend is paid to him. He would have no control even though he is affected by whether or not it is distributed, since if it is not distributed, he is subject to tax in the amount of income. This analysis would seem to break down for two reasons: (1) that this may be true in any situation in which he does not have a majority vote since the majority determines whether a dividend is paid, and (2) such a stockholder would have adequate protection by the easy means which he has for terminating the election under Subchapter S and thereby avoiding any tax on undistributed earnings.[34] However, no matter how strong the logic may be that a mere difference in voting rights alone should not constitute the stock a separate class for purposes of Subchapter S treatment, it would take a brave court to reach such a result, in view of the regulations and the legislative history and the literal language of the statute.

B. *Differences in Dividend Rights.* Classes of stock which do provide for differences in dividend rights do present the problem of allocation and therefore, as indicated above, form a justification for not applying Subchapter S treatment even though certain arbitrary rules might have been adopted to take care of these problems.

C. *Differences in Liquidating Rights.* Although it is uncommon for classes of stock to have similar rights as to dividends but to give one class a preference upon liquidation, the regulations would indicate that it would be considered a separate class of stock.[35] If the amount of liquidation is a set amount which does not vary depending upon earnings, this would cause substantial problems in allocating earnings. While undistributed earnings could be paid out in dividends to such a class, in the event they were not paid out they would not go to such a class upon

[32] INT. REV. CODE OF 1954 §674.
[33] No more than twenty percent of the corporation's gross receipts can be certain types of passive income. INT. REV. CODE OF 1954 §1372(e)(5).
[34] Apparently, a shareholder could terminate the election by transfering one share to a nonelecting stockholder or a trust. Treas. Reg. §1.1372-4(b) (1959).
[35] Treas. Reg. §1.1371-1(g) (1959).

liquidation. However, a class of stock, which upon liquidation shares equally with a preference equal to its par value, would not seem to present any problems in connection with allocating profits upon the gain side. In the event of losses an allocation problem would result. Although some possible solutions might be devised, as is indicated in discussing the rationale of the rule requiring one class of stock, it would certainly be a reasonable position that the complications attending this class of stock are so great that it should be considered a separate class.

The problems in the area of more than one class of stock do not usually result from the intentional establishment of classes of stock which the corporate law would view as being separate, but rather are due to specialized rules under the tax law. These rules give rights to certain individuals which result in the reclassification of their stock. This, without warning, retroactively voids the Subchapter S election.

III. Thin Capitalization

A current problem under the one class of stock rule, which may only be the predecessor to a number of other possible problems, is the treatment of a corporation that is thinly capitalized.[36] The Service has taken the position in its regulations that if a debt obligation is actually stock, it will be considered to be a second class of stock.[37] The Service has taken the position in litigation that if the corporation is thinly capitalized, the debt does constitute stock.[38]

A. *Analysis of thin capitalization under the rationale of the one class requirement.* On first analysis, the question of ease of allocation of gains and losses may not seem to pose a significant problem in the case of thin capitalization. The rights of debt, as specified by the instrument, at least are fixed; and there is not the question, as there is for preferred stock, of discretionary action by the board of directors in declaring dividends. Certainly, a loss by the corporation is borne by the common stockholders; and the Subchapter S provisions take care of the situation where losses exceed the basis of the common stock, and the common stockholder has debt, by permitting the recovery of the debt after the entire basis in stock has been consumed.[39]

The existence of the above described provision should be given significant weight in determining the treatment to be given to Subchapter S corporations in the case of thin capitalization. A situation in which the losses exceed the stockholder's basis in his common stock and would

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36 A corporation is thinly capitalized, if some or all of its debt is treated as equity for tax purposes. The term is derived from the fact that normally such corporations have a high ratio of debt to equity. However the doctrine has developed to relying on factors other than such ratio.

37 Treas. Reg. §1.1371-1(g) (1959).

38 Catalina Homes, Inc., 33 P-H Tax Ct. Mem. 1491 (1964); Henderson v. United States, 245 F. Supp. 782 (D. Ala. 1965); W. C. Gamman, 46 T.C. No. 1 (April 4, 1966).

39 Int. Rev. Code of 1954 §1376.

apply against the stockholder's debt would be one which would raise questions of thin capitalization. Thus, Congress clearly intended to make some provision for this case.[40] However, the thin capitalization problem has the potential of presenting the same difficulty in allocation as concerned the Senate Committee in the 1954 reports. Assume the corporation in 1963 has $300 worth of income after deducting interest of $100 which is later determined to be nondeductible by reason of the corporation being thinly capitalized. Therefore, the corporation has taxable income of $400. If the interest was paid out this would mean that although the corporation has $400 taxable income, presumably it would have only $300 of undistributed taxable income. The distributed $100 would be considered a distribution of earnings. If the $100 of interest were not distributed until 1964, and the corporation had no income that year and no accumulated earnings and profits, it would not be taxed to the holders of the notes. This result would occur because the entire $400 in 1963 was treated as undistributed taxable income and the $100 distribution in 1964 was treated as a dividend.

The problem arises only because the interest is not treated as interest and can be avoided by permitting it to be treated as interest.

Furthermore, it is submitted, that the likelihood of such events occurring in the thin capitalization case are considerably less than in the case of preferred stock. It is unlikely that in a thin capitalization case interest would be paid in a year in which no earnings of the corporation were earned. The mere fact of the payment of interest in such a year would be a strong indication that the corporation was not thinly capitalized but was treating the amount as debt. Whereas, in the case of preferred stock, it may well be that dividends would be continued on the preferred if there were past earnings, even though there were no earnings in the current year. Furthermore, if the debt is held pro rata by the holders of the common stock, it is fair for the interest payments not to be subject to tax since a tax has been paid by the common stockholders on these amounts. It would be quite likely in a thin capitalization case that the debt would be held by the same people holding the common stock, whereas in the case of preferred stock there would be much less likelihood that the debt would be held by the holders of the common.

It should be pointed out that there is no problem of allocation in situations where the debt does not bear interest or in cases in which interest is not paid in the years in which there are no earnings. In view of the limited likelihood of the various events taking place and in view of the fact that the sections contemplated that a corporation might at least be so close to being thinly capitalized that it would have losses that would exceed the total amount of the common stock, the Service could

[40] It is, of course, theoretically possible for the debt to have been incurred at some time prior to the losses when it appeared that the debt could be repaid.

make a different determination of the relative weight to be given to the the problems of allocation as compared to the merits of allowing small businesses to formulate their own corporate structure.

B. *Analysis in terms of the factors affecting thin capitalization.* The factors which have been considered in determining whether a non-Subchapter S corporation is thinly capitalized are beyond the scope of this article.[41] It is assumed that the tests for a Subchapter S corporation will be no more severe.[42] Rather the question of thin capitalization in the Subchapter S corporation might quite justifiably be given different consideration than that for normal corporations. The thin capitalization cases have normally arisen as controversies concerning three tax consequences: (1) the deductibility of interest paid by the corporation,[43] (2) the effect of the distribution of the funds from the corporation in payment of the principal,[44] (3) the treatment of the loss on the debt.[45] The doctrine of thin capitalization arises because a stockholder dealing with his own corporation may well not deal with it as disinterestedly as third persons would, and therefore the name which certain transactions are given cannot be allowed to govern tax consequences in which the tax treatment would be favorable to the shareholder. In a Subchapter S corporation these favorable effects, however, are not available.[46]

In determining the capitalization of a normal corporation, the fact that interest is deductible to the corporation and thus is a lesser net expense to the corporation than dividends is commonly considered. In a Subchapter S corporation, however, since there is no tax at the corporate level, there is no question of attempting to avoid the double tax by paying interest rather than dividends. There can be no incentive to capitalize a corporation to obtain this tax advantage.

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[41] For articles dealing with this subject see: Caplin, The Caloric Count of a Thin Incorporation, 43 MARQ. L. REV. 31 (1959); Bittker. Thin Capitalization; Some Current Questions, 34 TAXES 830 (1956); Crumbley, Avoid Unintentional Disqualifications of Subchapter S Corporations, 44 TAXES 374 (1966); Aarons, Debt v. Equity: Special Hazards in Setting Up the Corporate Capital Structure, 23 J. TAXATION 194 (1965); Dixon, The Interest-Dividend Syndrome: What are the Criteria Now, N.Y.U. 24TH INST. ON FED. TAX 1267 (1966).

[42] However, it may be more advisable to be more cautious in dealing with Subchapter S corporations because of the risks involved. In view of the factual nature of the problem of thin capitalization, advance rulings cannot be obtained. Rev. Proc. 31, 1964-2 CUM. BULL. 947.

[43] *See e.g.,* Gooding Amusement Co., Inc. v. Commissioner 236 F.2d 159 (6th Cir. 1956); Wood Preserving Corp. of Baltimore, Inc. v. United States, 347 F.2d 117 (4th Cir. 1965); Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963).

[44] *See e.g.,* Gooding Amusement Co., Inc. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964); P. M. Finance Corp. v. Commissioner, 302 F.2d 786 (3rd Cir. 1962).

[45] Gilbert v. Commissioner, 262 F.2d 512 (2nd Cir. 1959); Arlington Park Jockey Club, Inc. v. Sauber, 262 F.2d 902 (7th Cir. 1959).

[46] Caplin, Subchapter S and its Effect on the Capitalization of Corporations, 13 VAND. L. REV. 185, 191 (1959).

Similarly, the obtaining of cash from the corporation as repayment of a debt is utilized in normal corporations in order to distribute accumulated earnings of the corporation without paying a dividend tax. Since earnings of a Subchapter S corporation are immediately taxable to the shareholder and can be distributed to him tax free, this incentive is substantially reduced.[47]

The question of the loss treatment is one which is confined to normal corporations. An individual who loans money to a corporation, unless he can show that he is in the business of lending money, cannot get an ordinary deduction.[48] In fact, the situation is much reversed by the use of section 1244 stock, where the ordinary loss benefit is normally available to stock. Thus, in the Subchapter S corporations, the classification of advances to the corporation as debt rather than as contributions to capital, will seldom if ever be motivated by tax considerations, which is not the case with non-Subchapter S corporations. Therefore, the question of classifying a Subchapter S corporation as being thinly capitalized, basically relates to the area of qualifying for Subchapter S treatment rather than any other tax consequences. Viewed in that light, classifying such amounts as bona fide debt would not result in tax avoidances from a Subchapter S corporation's point of view.

Because of the lack of any tax advantages in having debt in a Subchapter S corporation, some of the early writers assumed that there would be no thin capitalization problem in Subchapter S corporations.[49]

C. *Case Law Development.* Despite the above arguments the Service has taken a clear position in its regulations that it will deny Subchapter S treatment if a corporation is thinly capitalized.[50]

The first case to raise the question of thin capitalization in a Subchapter S corporation was *Catalina Homes, Inc.*[51] A Mr. Spano controlled 65% of the corporation's stock. He owned 51% outright and was voting trustee of a voting trust holding another 14% owned by the other members of his family. A Mr. Blackshaw controlled the other 35% of the stock. He owned 1% outright and was voting trustee of a voting trust holding 34% of the stock, in which his son had the beneficial interest. The initial amount contributed for the stock was $10,000. Mr. Spano loaned the corporation $45,500 on open account, and Mr.

[47] It would still be applicable, if there were earnings and profits accumulated prior to making the election. However, to distribute these, loans would have had to have been made prior to making the Subchapter S election. Otherwise, the funds advanced on the loans would be merely repaid.

[48] Treas. Reg. §1.166.5 (1959) ;*see e.g.,* Whipple v. Commissioner, 373 U.S. 193 (1963).

[49] Manly, Election under Subchapter S can Eliminate Thin Incorporation Problem, 9 J. TAXATION 322, 323 (1958) ; Note, How to use Election under New Law to Save Taxes on Small Corporation Owners, 9 J. TAXATION 263 (1958) ; *but see* Roberts and Alpert, Subchapter S: Semantic and Procedural Traps in its Use; Analysis of Dangers, 10 J. TAXATION 2 (1959).

[50] Treas. Reg. §1.1371-1(g) (1959).

[51] 33 P-H. Tax Ct. Mem. 1491 (1964).

Blackshaw loaned it $24,500 on open account. (It should be noted that these are in direct proportion to their families' holdings.) In addition, at the end of the year, the corporation was indebted to banks in the amount of $93,600. There was a stockholder's agreement between Spano and Blackshaw which contained provisions that the balances of the loans would bear 5% interest payable from time to time as determined by the board of directors and that the stockholder's advances were preferred over the no par common stock to the extent that dividends could not be paid on the common stock until the advances and a 5% return had been paid to Spano and Blackshaw.[52]

The court, after analyzing the various factors involved, determined that the corporation was thinly capitalized. It considered taxpayer's argument that there was no tax avoidance purpose. The court conceded that the interest deduction advantage was not available but pointed out that this is not the only tax avoidance purpose. However, it did not indicate any other tax avoidance purposes that would be available in a Subchapter S corporation. The court then held, without elaborating its reasoning, that the advances constituted a separate class of stock.[53] Certainly, these advances involved all the aspects of preferred stock except the labeling as such. In addition, there would be some practical difficulty in allocating profits, in this situation, as the taxpayers who made the advances did not own the common stock. However, the company had been profitable, and there was no indication that there had been payments of interest in years in which the company did not have earnings.

In *Henderson v. United States*,[54] the Henderson Mining Co. had capital stock of 30 shares for which $3,000 had been paid. Mr. Henderson owned 18 shares, and Mr. Anderson and Mr. Ward each owned six shares. They were engaged in a mining business and acquired machinery having a cost in excess of $143,000. The board authorized borrowing of $150,000. Shortly after organization, Mr. Henderson advanced $36,000. The other shareholders made pro rata advances. The corporation lost $22,000 in its first year of operation. The question before the court is the deduction of the loss on Mr. Henderson's tax return. Promissory notes providing for 8% interest had been issued for the advances. However, no interest had been paid by the end of the first fiscal year, although interest was paid thereafter. The court discussed the question of thin capitalization and determined that the advances were devoted to the risk of the business. The court, without discussion, found that the

[52] There is an interesting question of fact that is not completely explained. The court notes that some $33,000 had been distributed to shareholders which was considered dividends for tax purposes, although it was stipulated that no dividends had been paid.
[53] Catalina Homes, Inc., 33 P-H. Tax Ct. Mem. 1491, 1499 (1964).
[54] 245 F. Supp. 782 (D. Ala. 1965).

advances constituted a second class of stock and that Subchapter S corporation treatment was not available.[55]

A different result was reached in the case of *Gamman v. Commissioner.*[56] This case involved a Subchapter S corporation organized to build an apartment-motel for the Seattle World's Fair. The corporation had two 50% holders, each having paid $200 for his capital stock. At the end of 1962, the corporation had a deficit of $183,000. By this time the shareholders had advanced $245,000 and guaranteed long-term loans of $845,000. The court had little difficulty in determining that the corporation was thinly capitalized but had more difficulty with the question of whether or not the advances constituted a second class of stock. The court first considered the regulations and held them invalid as being an extension or modification of the law and beyond the Commissioner's power. The court considered 1958 legislative history and later acts which seemed to indicate that the question was one of administrative convenience. It pointed to the provisions of section 1376 where the statute contemplated that stockholders would loan money to a Subchapter S corporation. The court believed that the question could not be resolved by an arbitrary rule but required analysis of whether the loans, in fact, gave the owners any rights different than those given by the common stock. The court reasoned they did not.[57] The debt was held in the same proportion as the stockholdings, and the terms of the notes, in effect, had been waived by the taxpayer. Furthermore, whatever preferences they received were only those among the stockholders. The court also pointed out that, in bankruptcy, these loans would have been subordinated to other claims. The court indicated in dictum that it had some doubts as to the applicability of the thin capitalization doctrine to Subchapter S corporations due to the fact that there was no question of avoiding a double tax on corporate earnings.

The decision was made by the whole court and there were concurring and dissenting opinions. The concurring opinion comes to the same conclusion but does not invalidate the regulations. It rather says that the regulation deals with a situation in which the debt is similar to the stock and that the regulations do not apply when the debt has some different characteristics. It is interesting that the majority reaches its conclusion because it feels the debt to be identical to stock in its characteristics, while the concurring opinion places emphasis upon the fact that the debt had the technically different characteristics of being callable upon demand and bearing interest. There is a dissent written by Judge Raum based upon the broad theory that the Commissioner's regulations are to be treated as valid unless unreasonably inconsistent with the statute. He dodges the question of reconciling the regulations with

[55] *Id.* at 786.
[56] 46 T.C. No. 1, 1 (April 4, 1966).
[57] *Id.* at 9.

the legislative intent. He states that the position of the regulations is consistent with whatever legislative purpose may have induced Congress to exclude small business corporations with more than one class of stock from Subchapter S treatment. He concludes that the regulations are not inconsistent with the words of the statute and that the majority has spelled out no contrary legislative intent.[58]

The *Gamman* decision was followed in *Lewis Building and Supplies, Inc.*[59] Lewis and his wife owned 700 shares and advanced $12,500 to the corporation. Laws and his wife owned 300 shares and advanced $6,000; the shares were purchased for $1.00 per share. Demand notes were issued for the advances; interest was payable only on demand. Although the advances were not in proportion to stockholdings, the court found that the corporation was thinly capitalized. It rejected the government's contention, based on the regulations, that the advances constituted a second class of stock as a matter of law. It found that the stockholders received no greater or different rights by reason of the advances.

D. *Future implications of the Gamman decision.* Undoubtedly, the conflicts created by the court decisions will lead to many more decisions in this area. Close questions of fact may be involved in the resolution of these problems. It well may be that the *Gamman* decision will be interpreted as one in which the purported debt has to be carefully examined to determine whether it is identical to stock and therefore not a second class of stock. This is rather an ironic rule since then the more clearly a corporation is thinly capitalized, the more likely the debt will not be considered a second class of stock. The case which has a close question of thin capitalization is one which will be held to involve a second class of stock. For example, if the debt is not pro rata, it might be considered a second class of stock, because it does give different rights than common held pro rata. This is also the situation which presents the greatest administrative problem in a thin capitalization case.

The terms of payment of interest may be significant. It may be better to have advances which bear no interest on their terms. Then the advances may be considered to have the same characteristics as common stock and to give the person no greater rights. It is important to note, however, that the *Gamman* case did not depend in its determination upon what rights happen to be spelled out in the particular debt agreement; rather, it looked to what the actual relationship was and whether the debt had given the parties any actual additional rights. Perhaps a much more satisfactory solution to the problem would be that suggested in *Gamman*—that the whole doctrine of thin capitalization is not applicable to the Subchapter S situation. If that is the position taken, there

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[58] *Id.* at 14.
[59] T.C. Memo 1966-159 (June 30, 1966).

are no difficulties in connection with profit allocation, and there would be no reason for denying Subchapter S treatment.

Even if the thin capitalization doctrine is to apply, a determination could be made that the debt does not constitute stock and thus cannot constitute a separate class of stock. This has some verbal attractiveness as it avoids the difficult contention that a note which has a stated interest rate and a stated maturity is the same "class of stock" as a common stock certificate. On the other hand, it would seem to create problems in connection with the allocation of earnings. This would be particularly troublesome in a case where some interest were paid, which would neither be deductible nor able to be considered as a dividend.

E. *The authority to be given regulations.* It has long been established that in construing a statute, substantial weight should be given to any contemporaneous interpretation by those administrative officials appointed to carry it into effect.[60] In tax matters this doctrine might have been limited to procedural questions[61] in view of the government's self interest in the outcome.[62] However no such limitation was imposed.[63]

Certain sections of the Internal Revenue Code directly delegate power to issue regulations concerning both procedural matters[64] and substantive questions.[65] Regulations issued pursuant to such delegations should be given particular weight and probably will be upheld unless arbitrary.[66] The constitutionality of such delegation has been upheld.[67] At the other extreme, if the statute is clear, regulations may not expand or change its meanings.[68] Both of these principles, although stated as specialized situations, are probably contained in the general test that regulations will be upheld unless they are unreasonable or inconsistent with the statute. It is interesting to compare the statement of this test in a case upholding the regulations:

> This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons.[69]

with its statement in a case overruling the regulations:

[60] Edward's Lessee v. Darby, 7 U.S. (12 Wheat.) 206 (1827).
[61] Boske v. Comingore, 177 U.S. 459 (1900).
[62] Lykes v. United States, 343 U.S. 118 (1951) (Jackson dissenting opinion).
[63] *See e.g.,* Lykes v. United States, *supra* note 62.
[64] *See e.g.,* INT. REV. CODE OF 1954 §1375(e)(3).
[65] *See e.g.,* INT. REV. CODE OF 1954 §1502.
[66] Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).
[67] Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916).
[68] Koshland v. Helvering, 298 U.S. 441 (1936); United States v. Calamaro, 354 U.S. 351 (1957); Commissioner v. Acker, 361 U.S. 87 (1959); United States v. Graham, 110 U.S. 219 (1884); Morrill v. Jones, 106 U.S. 466 (1882).
[69] Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948).

> The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. . . . And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable.[70]

These statements of the test raise interesting questions of at least theoretical interest. What type of construction might be in harmony with the statute and still be unreasonable? If a court in the absence of a regulation would come to a contrary conclusion from the regulation, is it likely to find that such a regulation is reasonable and in harmony with the statute? Do the regulations really do substantially more than put the burden of proof on the taxpayer?

Although many of the cases have language indicating that strong weight is to be given the regulations,[71] the courts also independently consider the merits and usually find the regulation's interpretation to be in accord with their own interpretation.[72] On occasion, however, courts have found the regulations to be out of harmony with the statutes and overruled them.[73]

If a convincing argument can be made that a corporation thinly capitalized should not be denied Subchapter S treatment, it would not seem to be too difficult to extend the argument to show that the contrary regulations are out of harmony with the statute and unreasonable.

Special weight, the courts state, is given to regulations which have been outstanding a lengthy period of time and which have not been contradicted by reenactments of the sections by Congress.[74] Although amendments have been made to Subchapter S since the adoption of the regulations, Congress does not appear to have given consideration to the regulations with respect to the one class of stock limitation. It would seem unrealistic, therefore, to contend that Congress has approved the regulations which have been issued.

F. *The necessity to have debt in a Subchapter S Corporation.* It is submitted that in many cases there is no need to have any debt owing stockholders of a Subchapter S corporation and that the careful practi-

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[70] Manhattan General Equipment v. Commissioner, 297 U.S. 129, 134 (1936).

[71] Fawcus Machine Co. v. United States, 282 U.S. 375 (1931); Colgate Co. v. United States, 320 U.S. 422 (1943).

[72] *Id.;* Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941); Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

[73] Commissioner v. Acker, 361 U.S. 87 (1959); United States v. Calamaro, 354 U.S. 351 (1957); Coady v. Commissioner, 33 T.C. 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961); Lane, Attacking the Regulations, 52 A.B.A. JOURNAL 187 (1966).

[74] *E.g.,* Brewster v. Gage, 280 U.S. 327 (1930); Morrissey v. Commissioner, 296 U.S. 344 (1935); United States v. Hermanos y Compania, 209 U.S. 337 (1908).

tioner will advise his clients to advance additional sums in exchange for stock or else as contributions to capital rather than as loans. For example, if advances are to be made on a pro rata basis, whether or not the payments are made and labeled interest or made and labeled dividends, has no economic or tax consequences to the shareholders. The corporation pays no tax and the shareholders will be taxed on the amount in either event, and the shareholders will be taxed to the full extent of earnings whether distributed or not.

Thus, for example, if A owned 60% of a corporation and B owned 40%, A advances $6,000 and B advances $4,000. If they are to be paid $300 and $200 on this advance yearly, it will make no difference whether these payments are called interest or dividends. Assume that in 1964 the corporation earns $1,000 before making these payments. If the payments are labeled interest, the corporation will have $500 income and will pay $300 to A and $200 to B, which will be taxable to them as as interest. A will be taxed on an additional $300 and B on an additional $200 as undistributed earnings, or these amounts can be distributed to them. In the event the corporation has no earnings in 1965 but makes the payments to them, A would be subject to tax on $300 and B on $200 if the payments are considered interest. There would be a net loss of $500, A getting a deduction on his tax return of $300 and B of $200. The same results would ensue if the amounts were labeled dividends. In 1964 the stockholders would be taxed on $500 of dividends and $500 of undistributed income; in 1965 they would not be taxed as the distribution would be of previously taxed income.[74a]

There is the risk that in the event of a transfer of stock the credit for previously taxed income is lost;[75] and therefore it is advisable in this, as in all cases, to make distributions of the entire amount of income. Even if such distributions are not made, this seems to be a small risk compared to the risk of a possible thin capitalization problem. In the event of repayment of the loan, if it is considered a bona fide loan, the amount that can be repaid without any tax is a return of capital. Similarly, any amount paid in redemption of stock may be repaid without tax, if all the earnings have been actually or constructively distributed each year. The amount distributed will merely reduce the stockholder's basis in his stock. However, the basis of the remaining stock would not be reduced below what it was, had the same amount been loaned to the corporation and repaid. If there are undistributed earnings, which consist entirely of previously taxed income, again there would be no tax on the distribution. If, however, the corporation has accumulated earnings and profits which are not entirely previously taxed income, any distribution to the shareholder would be a dividend. A re-

[74a] If the shareholder had no previously taxed income, still there would be no tax in 1965 if the corporation had no earnings and profits.
[75] Treas. Reg. §1.1375-4(e) (1959).

demption of part of a shareholder's stock would be such a distribution, unless only some stockholders were redeemed and the redemption was substantially disproportionate.[76] Such a situation might occur if a corporation's earnings and profits exceeded its taxable income and there was a stock transfer,[77] or because the corporation had operated prior to electing Subchapter S treatment and had earnings and profits from this period of time. Because of this problem, when a corporation which has accumulated earnings and profits elects Subchapter S, it may be more desireable to utilize debt for any additional advances. Debt will be more advantageous only if there is a reasonable chance of repayment. If there is such a chance, there should be a strong case to rebut a thin capitalization argument.

A somewhat more difficult problem arises in the event of debt on a non-pro rata basis, because the rights of the parties, in effect, are changed if they take additional stock which has an equal participation in equity on a non-pro rata basis. If the stockholders are not related parties, there are important non-tax considerations involved. A stockholder advancing additional funds for debt to a corporation which could be considered thinly capitalized, when similar advances are not being made by the other stockholders, should give careful consideration to whether he is receiving adequate return for his advances. There may be cases where there is a substantial risk that the advance will not be able to be repaid, but the stockholder making the advance wants it to have priority over the stock of the other stockholders. In the case of corporations in financial difficulty, it may be difficult for the parties to agree on the value of the stock, and the new advance, if it were taken in the form of stock, would constitute a substantial percentage of the total stock. In such situations, however, there would normally be operating losses. Having a larger percentage of stock would increase the amount of loss deductible on the stockholder's personal return, whereas having more debt would not increase the shareholder's percentage of the loss, although it does increase the amount of basis against which the loss may be taken.[78] Furthermore, loans in such a situation may be considered a second class of stock resulting in the inability of any of the stockholders to deduct the operating losses.

If non-pro rata advances are being made when the stockholders are related, the reason for not taking stock must be analyzed. Stockholders who, for tax purposes, may be considered related may in fact be operating from the same motives as unrelated stockholders described above. However, the reason for one stockholder making an advance when others do not, may be that he is the only one with funds to invest and that he wants to leave the potential for growth with the other stock-

[76] INT. REV. CODE OF 1954 §302.
[77] See Treas. Reg. §1.1375-4(e) (1959).
[78] INT. REV. CODE OF 1954 §1376(b) (1959).

holders. In effect the stockholder may be making a type of gift by loaning the funds rather than taking stock. The estate planning advantages of such a procedure must be carefully weighed against the danger of a thin capitalization contention which voids the Subchapter S election.

It is normally advantageous to distribute all of a Subchapter S corporation's earnings. Such earnings are taxed to the shareholders whether or not distributed, and there is the possibility that the earnings cannot later be distributed tax free. Many corporations, however, require the retention of the earnings in the business for expansion.[79] If the corporation has no earnings and profits from a period prior to electing Subchapter S, stock can be redeemed at any time without danger of dividend taxation as there are no earnings and profits. This can be done, since undistributed taxable income which is required to be taxed to the shareholders reduces the corporation's earnings and profits.[79a] The corporation should not distribute the earnings and have the stockholders loan the cash back to the corporation, or even to distribute the earnings in the form of notes or accounts payable. These procedures are subject to attack for thin capitalization, since the loans are made pro rata. If a cash distribution has been made, reinvestment should be in the form of stock not debt. If the corporation has undistributed earnings from a period prior to the adoption of Subchapter S, there is still the disadvantage of not being able to redeem the stocks on a tax free basis unless the distribution is substantially disproportionate.[80]

G. *Stockholder's guarantee of third parties' debt.* The courts have held that a debt to a financial institution guaranteed by a shareholder may raise problems of thin capitalization.[81] Such a rule was necessary in order to prevent evasion of the rules on thin capitalization. The courts treat such a bank loan to the corporation no differently than if the shareholder had borrowed money from the bank and then invested it in the corporation on the same terms that the corporation has with the bank. Unfortunately, in the case of small closely held corporations, guarantees of corporate loans are almost automatically required by banks. The existence of a guarantee does not necessarily result in a finding of thin capitalization. The important factor would seem to be whether the loan is really being made to the corporation, or whether it is really being made on the strength of the credit of the shareholders and only technically made to the corporation.

There have not yet been cases on guaranteed loans involving Subchapter S corporations. Although it is likely that an attempt to extend the doctrine will be made, there is a technical problem in finding what

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[79] Careful consideration must be given in such cases to the advisability of continuing the Subchapter S election. If the corporate tax bracket is lower than the shareholders', it would seem advisable to terminate the election.
[79a] INT. REV. CODE OF 1954 §1377(a).
[80] INT. REV. CODE OF 1954 §302.
[81] Murphy Logging Co. v. United States, 239 F. Supp. 794 (D. Ore. 1965).

constitutes the second class of stock. The stockholder has made no advance to the corporation, and it is difficult to classify the bank as a stockholder. Perhaps it can be viewed as if the stockholder borrowed funds from the bank and loaned them to the corporation. This does not create any additional rights in the shareholder other than those of his common stock, so even if the corporation is thinly capitalized there is no second class of stock. To find a second class of stock requires assuming that the debt to the bank is really to the shareholder and that it is a second class of stock. Despite such difficulties it is likely that no distinction will be drawn between direct loans to a corporation by a stockholder and the guarantee of bank loans in situations where the credit of the shareholder is being relied upon. Again, in those situations where practical, it would seem much more advisable—even in the case where the bank loan is really being made on the strength of the corporation's credit—for the shareholders to borrow the funds and buy additional stock with it, receiving distributions from the corporation with which to pay off the bank loan.[82]

It appears that the question of thin capitalization disqualifying a corporation for Subchapter S treatment is an extremely treacherous trap for the unwary. Those carefully advised can often obtain exactly what they desire by not making loans to their corporations but by purchasing additional stock.[83] It seems particularly unfortunate that those small corporations without adequate tax counseling are to be trapped in this manner and subjected to what may prove to be substantial unexpected tax liabilities. The purpose of Subchapter S was to aid the small closely held corporations, rather than to require them to have to constantly consult tax counsel.

IV. Shareholder Agreements

The development of law in the areas of thin capitalization may be a preliminary to an expanded attack on Subchapter S corporations. It may be contended that a second class of stock can be artificially created. Perhaps the most fruitful of such areas for the government is shareholder agreements. It is quite common for small corporations to have agreements among shareholders on various matters.[84]

Agreements to which the corporation is a party are particularly troublesome. The fact that a shareholder's rights are determined by a separate contractual arrangement with the corporation rather than by their description in the articles of incorporation seems a tenuous basis for a distinction. Of course if the agreement gives all the shareholders identical rights, it should not create any problem of a second class of

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[82] See Section III-F *supra* for an analysis of tax consequences.

[83] It appears that this could probably have been done in the Subchapter S cases recently litigated.

[84] Some authors have viewed such agreements as essential. Moore and Sorlien, Adventures in Subchapter S and Section 1244, 14 Tax L. Rev. 453, 485 (1959).

stock. At times, however, the majority stockholder or holders may not be subject to any restrictions under the agreement. Restrictions may be placed solely on minority holders for quite bona fide business reasons, and similar restrictions might be inappropriate or meaningless if applied to the majority.

If the corporation is not a party to the agreement, it being merely among the shareholders, it would seem that this would not create a separate class of stock. A separate class of stock should be determined only by the relationship between the corporation and the shareholders themselves. Perhaps it may be significant whether steps have been taken to make such an agreement binding on subsequent purchasers of the stock.[85]

The courts, it is hoped, will be less willing to find a second class of stock in the case of contractual agreements between shareholders of the corporation, if these agreements, in fact, have no effect upon earnings and liquidation rights. The rationale behind the one class of stock limitation would not be applicable. The courts should find it easier to limit the requirement to its rationale, when they are not faced with a direct case of a second class of stock, but are being asked to construct such a class in order to deny the Subchapter S treatment.

Various types of agreements on voting are common, the clearest example being a voting trust. The Commissioner has taken the position in his regulations that a voting trust is not an individual holder of stock, and thus a corporation having a voting trust as a stockholder would fail to qualify under Subchapter S.[86] Even if this argument is not available to the Commissioner, he might contend that different voting rights were being given to different shareholders. In *Catalina Homes, Inc.*,[87] the Commissioner, in attacking a corporation having voting trusts, contended both that the trusts resulted in two separate classes of stock and that the trusts constituted stockholders other than individuals. Although the court did not pass on these contentions, since it decided the case on the grounds of thin capitalization, it did indicate in dictum that it questioned whether the Commissioner's interpretation was reasonable and in accordance with the congressional intent.

As analyzed previously,[88] the question of differences in voting rights would have no applicability to the question of allocation of profits (the rationale behind the limitation under Subchapter S.) The Treasury has ruled, however, that agreements which allocate voting rights constitute a second class of stock.[89] In that ruling a partnership

[85] See Weinstein, Stockholder Agreements and Subchapter S Corporations, 19 TAX L. REV. 391 (1964).
[86] Treas. Reg. §1.1371-1(e) (1959).
[87] 33 P-H Tax Ct. Mem. 1491 (1964) discussed at footnote 51 and accompanying text.
[88] See Section II-A *supra*.
[89] Rev. Rul. 226, 1953-2 Cum. Bull. 341.

had been incorporated which had had eight active partners and two limited partners. Although there was only one class of voting common stock authorized, there was a shareholder agreement which provided that any shareholder not actively engaged in the business would grant an irrevocable proxy to one or more of the active shareholders to vote his shares. The limited partners granted such irrevocable proxies. The ruling holds that this constitutes more than one class of stock because the voting power is disproportionate. The Commissioner's contention in *Catalina Homes* and the holding in the revenue ruling are particularly significant, not only because they involve the extension of the one class of stock rule to questions of voting rights, which seems inappropriate, but because they are applied to situations in which the corporation is not a party to the agreement. Although both situations involved voting arrangements which did not involve all shareholders, a voting trust composed of all shareholders may be subject to attack since the voting trustees have disproportionate power.

Catalina Homes and the ruling raise a number of questions. What if a proxy is granted for one year? What is the effect of agreement to grant a proxy for only one meeting or an agreement to grant a proxy to vote on certain specific issues? How important is it that the proxy is revocable? What is the effect of agreements to elect certain individuals to the Board? Perhaps a distinction should be drawn between rights given to an individual because of the confidence placed in him by another individual, and a right given to a share of stock. It seems somewhat difficult to have differing classes of stock unless the rights would at least be binding on a successor holder.

Agreements which involve the required payment of dividends would not constitute a second class of stock, if the dividends were to be paid to all stockholders. If dividends are to be paid only to some shareholders, there would be a second class.

It is quite common and often advisable for shareholders of a closely held corporation to enter into an agreement giving the corporation or other shareholders a right of first refusal on the sale of the stock. These agreements, it would seem, would not create any problems of allocation of profits. However, if only some shareholders are subject to such rights of first refusal, which may often be the case, an argument could be made that there are two classes of stock. This is particularly true in the situation where the corporation is a party.

A more troublesome type of agreement is one in which there is a repurchase obligation or option upon the occurrence of certain events such as death or termination of employment, and there is a formula price. The formula price may be such that it could be argued to have an effect on the allocation of the rights to income. It might be contended, for example, that a formula which was based solely on the earnings would not give consideration to retention of profits in the business, and thus a shareholder should not be taxed on undistributed income because his class of stock does not benefit from it since it will be eventually purchased solely on the bases of the current earnings. This argument, however, would neglect the fact that the earnings retained would presumably contribute also to the future earnings of the business, and it would seem that there would be little inequity in treating this stock as having the same share of earnings as a share of stock not subject to such agreement. Nevertheless, if the agreement is not applicable to all shareholders equally, it may be contended that it results in differing interests in the assets or in a liquidation preference. The regulations state that either will constitute an additional class of stock.[90] Fortunately, the regulation language is not clearly applicable to such agreements, since they do not really modify liquidation or asset rights. Thus, such agreements can be permitted without having to attack the regulations.

The reasons for having such agreements not apply to all shareholders are not tax reasons. A closely held corporation, selling stock to its employees for incentive purposes, wants to restrict their holding period to that in which they are employees, since only then is the incentive applicable. Such an arrangement may be most important when the controlling interest in the corporation is held by individuals not active in the business and yet in that situation the agreement cannot apply equally to all shareholders. A required repurchase upon death may be necessary to solve a liquidity problem applicable to only some shareholders because of their age and the composition of their estate.

If, however, the rationale behind the rule is to be completely neglected, and the question is merely one of whether some shareholders have different rights than other shareholders, any shareholders' agreement, in which all shareholders are not treated the same, raises possible problems under Subchapter S. Before such agreement is entered into, a cautious tax advisor will obtain a ruling. It is hoped that, in the future, published rulings and regulations in this area will give taxpayers certain guide lines to determine what agreements are permissible.

It would be unfortunate to require that such agreements must necessarily apply to all shareholders. The application of certain rights of first refusal and redemption rights to the majority stockholder often would be meaningless and quite impractical to enforce. Thus, even if the agreement technically applied to all the shareholders, there would be the additional danger of a contention that this was merely a technical compliance. It would be argued that because the majority stockholders controlled the corporation, the agreement would not be ap-

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[90] Treas. Reg. 1.1371-1(g) (1959).

plied, in fact, to them. Such a doctrine would be extremely harmful to the congressional policy which was to aid a small business by allowing it to formulate its legal form without having to give consideration to tax factors. The strong business need for shareholder agreements in a closely held corporation, necessitates a clear and definite reconciliation of these agreements and the one class of stock requirement, if Subchapter S is to be a useful tool.

V. Contractual Rights

There may be a question of whether other types of contractual rights respecting nonstockholders give rise to a class of stock which is a second class. This problem would seem to be most severe in the case of transferable warrants or similar securities which can be converted into common stock. Since such warrants or rights, until they are exercised, normally have no interest in liquidation or earnings or voting, it can be argued that they should not constitute a second class of stock until exercised. The regulations provide that an authorized second class of stock that is not outstanding will not void a Subchapter S election.[91] However, it would seem that such warrants might well raise the mechanical problems previously discussed relating to previously taxed and undistributed earnings. If a corporation has outstanding warrants which can be converted into common stock and yet does not distribute all of its earnings, the original stockholders may have paid tax upon earnings, which, after the warrants are converted, are partly applicable to the warrant holders. Thus, we have the same problem which was explained in the Senate Finance Committee report.[92] For example, if in 1963 a corporation has 100 shares of stock outstanding and has earnings of $1,000, each holder of one share of stock would pay tax on $10 of income. These amounts are not distributed. If there are warrants outstanding which are converted in 1964, and in 1964 there is no income, the converted warrants qualify for 100 additional shares, so there are 200 shares outstanding. If the $1,000 of prior earnings are distributed, each shareholder would receive $5 of earnings. Those prior shareholders receive the amount free of tax as a distribution of undistributed earnings, but the tax treatment of those stockholders who converted warrants would depend upon whether the corporation had accumulated earnings. It may be argued that this problem is no greater than any situation in which shareholdings change from the time undistributed earnings are earned and the time they are distributed. This problem is one which involves such difficult mechanical problems that the shareholders should be required to take the risk of possible inequitable treatment on earnings when they decide to leave earnings undistributed. However, to the extent that this was the

91 *Ibid.*
92 S. Rep. No. 1622, 83rd Cong., 2nd Sess., 453 (1954).

rationale behind the requirement that there be only one class of stock, it would seem equally applicable to warrants. Furthermore, at the time the earnings are originally earned, the warrants, in effect, are increasing in value to the extent that the earnings are earned and are not being distributed.

The above problem on the question of warrants would be equally applicable to convertible debtor to any other right, such as a mere subscription agreement, which gave a shareholder the opportunity to purchase stock in the future.

It would be expected that a salary agreement which has bonus computations which were based on profits or earnings should not result in any problem of a second class of stock. Presumably such amounts would be payable and deductible for purposes of computing taxable income so as not to result in questions of previously undistributed earnings. However, if such a contract is with a shareholder, or if it is held that such salary is an unreasonable salary, it may well be that the contractual right to it is considered a class of stock which may have different terms than the common stock. Thus, the unreasonable compensation problem may develop into a problem equivalent to thin capitalization. In situations in which the salary is actually not paid within the year, the problem of distribution in the future gives rise to the same mechanical problems which have previously been considered. Here, as in the thin capitalization area, the tax avoidance motives which are normal in unreasonable compensation cases are not at all applicable in the Subchapter S area. Since there is no double tax, there is no desire for a stockholder to try to increase his salary rather than receiving the amount as dividends. However, the possibility of such an attack and again the disastrous effect of voiding a Subchapter S election indicates that care must be taken to make sure that compensation paid is, in fact, reasonable.

The danger illustrated by unreasonable compensation is equally applicable to many areas, such as favorable leases, where there is the possibility of constructive dividends.

This article has attempted to give some warning as to possible dangers lurking in the requirement of a single class of stock. At times the warnings may have had the appearance of a parade of horribles. It is hoped that before Subchapter S corporations are attacked in the manner indicated, the Service and the courts will give careful consideration to whether such attack is necessary to prevent abuse and whether such attack is not inconsistent with Congress's objective in enacting Subchapter S.