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Paul F. Jones

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Introduction

The Congress in 1958 added Subchapter S[1] to the Internal Revenue Code, which provides that certain qualifying small business corporations may elect not to be taxed as corporations but instead to have their income taxable directly to their shareholders.[2] The stated purpose[3] of Subchapter S was to allow small businesses to select their form of doing business, corporate or noncorporate, without regard to the tax consequences of such a decision.

Section 1371 (a) defines the term "small business corporation" for purposes of making a Subchapter S election:

> For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group . . . and which does not—
>
> (1) have more than 10 shareholders;
>
> (2) have as a shareholder a person (other than an estate) who is not an individual;
>
> (3) have a nonresident alien as a shareholder; and
>
> (4) have more than one class of stock.[4]

Problems have frequently arisen under the last of these requirements—the one class of stock rule—when thinly capitalized corporations have sought Subchapter S status.[5] The purpose of this note is to examine those problems, the position of the Treasury Department on the matter, and recent conflicting holdings in the courts of appeals, and to suggest some possible solutions to the problem.

I. Legislative History and Treasury Department Regulations

As noted above, the primary reason for the enactment of the Subchapter S scheme was to "[permit] businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."[6] Unfortunately, the legislative history of the 1958 act is silent on the reasons for the one class of stock requirement.[7] Some insight can be gained, however, from the legislative history of a similar proposal which passed the Senate

1 INT. REV. CODE OF 1954, §§ 1371-79.

2 *Id.* § 1373.

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

4 INT. REV. CODE OF 1954, § 1371(a).

5 *See generally* Bravenec, *The One Class of Stock Requirement of Subchapter S—A Round Peg in a Pentagonal Hole,* 6 HOUSTON L. REV. 215 (1968); McGaffey, *The Requirement That a Subchapter S Corporation May Have Only One Class of Stock,* 50 MARQ. L. REV. 365 (1966); Note, *Shareholder Lending and Tax Avoidance in the Subchapter S Corporation,* 67 COLUM. L. REV. 495 (1967). In general terms, a corporation is "thinly capitalized" if its debt far exceeds its equity capital (*i.e.,* if it has a high debt-to-equity ratio).

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

7 *Id.* at 88. The legislative history of the 1958 legislation simply restates the one class of stock rule without any explanation or justification.

in 1954 but was not included in the final version of the 1954 Internal Revenue Code as finally enacted by Congress. The Senate Report[8] on that measure made the following statement in justification of the one class of stock requirement:

> If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an adjustment, however, would be extremely difficult where there had been a transfer of common stock in the interim.[9]

It appears from the foregoing that the main concern of the Congress was simply to avoid possible administrative complexities. The Congress, for whatever reason, apparently did not envision thin capitalization as a problem in this regard.

In light of this, the initial Treasury Regulations seem overbroad in providing, in part, that "[i]f an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."[10] This put the Commissioner in a position to determine, in the case of a thinly capitalized corporation, that the purported debt was actually equity investment, and as such constituted a second class of stock, thereby voiding the Subchapter S election.

This regulation, however, after being invalidated by the Tax Court in *W.C. Gamman*,[11] was modified to read, in part:

> 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.[12]

The principal effect of this change was to allow the shareholders to make capital advances in the form of loans to the corporation in amounts proportional to their shareholdings and still not be deemed to have created a second class of stock. Even this regulation, however, has been invalidated by several different courts, and that is the issue on which the courts of appeals in the fifth and seventh circuits have recently taken opposite positions.

II. Case Development

As noted above, separate Treasury Regulations relating the one class of stock rule to thin capitalization have twice been invalidated: First, in their original

8 S. REP. No. 1622, 83d Cong., 2d Sess. (1954).
9 *Id.* at 453-54.
10 Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.
11 46 T.C. 1 (1966).
12 Treas. Reg. § 1.1371-1(g) (1966).

form, in *W.C. Gamman,*[13] a 1966 Tax Court case; and more recently the amended regulations were invalidated by two separate panels in the fifth circuit, in *Amory Cotton Oil Co. v. United States*[14] and *Shores Realty Co. v. United States.*[15] This portion of the note will examine the case development that led to *Amory, Shores Realty,* and the opposite holding in the seventh circuit, *Portage Plastics Co. v. United States.*[16]

The Tax Court, in a memorandum opinion, first dealt with the problem in 1964 in *Catalina Homes, Inc.*[17] In *Catalina,* advances made by two shareholders were shown on the corporation's books as accounts payable to these two shareholders, and not as loans.[18] The court found that these advances were actually contributions to the risk capital,[19] and not true loans. Further, the court in finding that these advances constituted a second class of stock seemed to be at least partially swayed by the existence of a stockholders' agreement which provided that no dividends could be paid on the nominal common stock until the advances by these two stockholders, plus five per cent annual interest thereon, had been paid.[20] The court found that this clearly indicated that these equity advances held a preferred status in relation to the common stock, and as such constituted a second class of stock, thereby making the Subchapter S election invalid.[21] It should be noted, in addition, that the advances made by the shareholders were not proportionate to their holdings in the nominal stock,[22] although the court did not rely on this fact.

The next reported case to deal with the problem was a 1965 district court case, *Henderson v. United States.*[23] Here, the three holders of the nominal stock made significant advances to the corporation; all advances, however, were exactly proportionate to the nominal stockholdings of the three shareholders.[24] The court first found that since the shareholders' unsecured advances were essential to inception of the corporate venture and that since no effort had been made to enforce the instruments evidencing the advances, that these advances represented risk capital, and therefore represented equity, and not debt, investment.[25] The court then applied the regulation then in force, finding that the loans constituted a second class of stock and declared the Subchapter S election invalid.[26]

The first significant break came in *W.C. Gamman*[27] in 1966. In *Gamman,* the Tax Court, with five judges dissenting, held that although pro rata advances by two equal shareholders of a corporation far in excess of their contributions to their corporation for stock were actually placed at the risk of the business and had

13 46 T.C. 1 (1966).
14 468 F.2d 1046 (5th Cir. 1972), *aff'g* 320 F. Supp. 951 (N.D. Miss. 1970).
15 468 F.2d 572 (5th Cir. 1972), *aff'g* 27 Am. Fed. Tax. R.2d 71-679 (S.D. Fla. 1971).
16 470 F.2d 308 (7th Cir. 1972), *rev'g* 301 F. Supp. 684 (W.D. Wis. 1969).
17 33 P-H Tax Ct. Mem. 64-1491 (1964).
18 *Id.* at 64-1494.
19 *Id.* at 64-1499.
20 *Id.* at 64-1493.
21 *Id.* at 64-1499.
22 *Id.* at 64-1498.
23 245 F. Supp. 782 (M.D. Ala. 1965).
24 *Id.* at 786.
25 *Id.*
26 *Id.*
27 46 T.C. 1 (1966).

the characteristics of equity capital, nevertheless these advances did not constitute a second class of stock.[28] In so holding, the court also held the following language of the regulation to be overbroad and invalid:[29]

> If a debt instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.[30]

The court found nothing in the statutes, committee reports, or purpose of the legislation that would justify such a rule.[31] Further, the court distinguished both *Catalina* and *Henderson* because neither actually addressed the question of the validity of the regulation.[32] Also, although *Gamman* invalidated the regulation only with respect to the facts of the case, namely advances in proportion to the holdings of the nominal stock, the court's interpretation of the legislative history certainly left open the possibility that the regulation would be invalid even in a case where shareholder advances were not proportional to their nominal shareholdings.

In *Lewis Building and Supplies, Inc.*,[33] the Tax Court found that loans evidenced by noninterest bearing demand notes were actually capital placed at the risk of the business.[34] However, even though the loans were not exactly proportionate to the nominal stock holdings,[35] the court cited *Gamman* and followed its rationale, finding no second class of stock.[36] The court also found, however, that the corporation had not filed a timely election and that therefore the election was invalid.[37]

Milton T. Raynor[38] presented a situation in which the books of the three corporations involved did not indicate which shareholders had contributed what amounts.[39] However, the shareholders had agreed among themselves that the amounts owed by each corporation were to be considered owed to the shareholders in proportion to their stockholdings, regardless of who had actually made the open account advances.[40] Despite the confusing corporate records this led to, the Tax Court found that these shareholder advances were within the regulation (as amended) and within *Gamman*, and that the corporation therefore qualified for Subchapter S status.[41]

The Tax Court in *James L. Stinnett, Jr.*,[42] went even further and invalidated the amended regulation[43] which required that the advances by the shareholders

28 *Id.* at 10.
29 *Id.* at 8.
30 Treas. Reg § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.
31 46 T.C. at 7-8.
32 *Id.* at 11.
33 35 P-H Tax Ct. Mem. 66-949 (1966).
34 *Id.* at 66-952.
35 *Id.* at 66-953.
36 *Id.* at 66-954.
37 *Id.*
38 50 T.C. 762 (1968).
39 *Id.* at 768.
40 *Id.*
41 *Id.* at 769.
42 54 T.C. 221 (1970), *appeal docketed,* 9th Cir., Sept. 23, 1970.
43 *Id.* at 230.

be made in amounts proportionate to their holdings of the nominal stock. In so holding the court said:

> We do not regard as controlling . . . the fact that "debt" characterized as "equity" capital may be disproportionate to the respective common stock interests of the stockholders. Accordingly, we must hold the regulation invalid as applied to this case. To hold otherwise not only would serve largely to defeat the purpose for which Congress enacted subchapter S, but would be inconsistent with the underlying scheme of the statute as exemplified by section 1376(b)(2).
>
> . . . .
>
> Not only is [section 1376(b)(2)] a clear indication that the statute contemplates that the stockholders of a subchapter S corporation would make advances or lend money to the corporation, but for the purposes of reflecting losses deducted by the stockholders in their returns, any resulting debt is treated as part of the stockholder's "investment."[44]

The court also indicated that since there were no foreseeable tax benefits,[45] the taxpayers should not be penalized for having a thinly capitalized scheme. The concurring opinion noted the harsh effects of a retroactive termination as not intended by Congress because small corporations customarily depend on stockholder loans and guarantees for financing.[46]

The Tax Court, in a memorandum opinion, cited and followed *Stinnett* in *H.R. Spinner Corp.*,[47] a case involving non-pro rata shareholder advances. Since the court was not willing to treat these as a second class of stock, it found that the debt-equity distinction was immaterial.[48]

Once again, in *Estate of William M. Allison*,[49] the Tax Court held that, even if non-pro rata advances were to be considered contributions to capital, rather than bona fide indebtedness, such advances and notes still do not constitute a second class of stock.[50] In somewhat of an understatement, the court noted the poor record of the Commissioner in ten cases which had taken up the issue:

> [W]e note that respondent [United States] has been singularly unsuccessful in convincing the courts that purported indebtedness, which has been found to constitute "equity," should be classified as a second class of stock, thereby disqualifying the corporation from the benefits of subchapter S.[51]

Citing *Stinnett*, the court in *Allison* found the thin capitalization approach not particularly relevant.[52] The court also noted in a footnote the fact that the Treasury Department had proposed to Congress that such advances ought not

44 *Id.* at 230-31.
45 *Id.* at 231.
46 *Id.* at 235.
47 39 P-H Tax Ct. Mem. 70-513 (1970), *appeal docketed*, 9th Cir., Aug. 28, 1970.
48 *Id.* at 70-516.
49 57 T.C. 174 (1971).
50 *Id.* at 178.
51 *Id.* (footnote omitted).
52 *Id.* at 179.

be considered a second class of stock. The suggestion, however, was not incorporated into the Tax Reform act of 1969.[53]

In *Brennan v. O'Donnell,*[54] in holding that shareholder advances which were actually equity did not constitute a second class of stock, the district court added its thoughts on the question of the appropriateness of a proportionality requirement:

> This court is persuaded that . . . to the extent the regulations insist that disproportionately held debt-equity disqualify a corporation from subchapter S treatment, they have overreached the statute and are invalid. This is not, of course, to say that debt-equity interests can never constitute a second class of stock—there well may be situations where such a conclusion is justified on a consideration on their impact on actual voting rights, dividend rights, and liquidation rights. But such a conclusion will not arise merely upon a determination that they are not held in "substantially the same proportion" as the formal stockholdings.[55]

The court also made the following observation on the policy underlying Subchapter S:

> Moreover, a stated purpose for the passage of subchapter S was to encourage the selection of business forms for reasons other than tax consequences—a purpose which will certainly be frustrated by a policy which prevents owners from putting new capital directly into their businesses once they have selected the corporate form.[56]

As is readily apparent from the foregoing, the Internal Revenue Service, aside from two early cases—*Catalina Homes* and *Henderson*—has had no success in its attempts to convince courts to follow its regulations concerning the one class of stock rule, either in their original or amended form.

III. The Current Conflict: *Portage, Shores Realty,* and *Amory*

The three cases of current significance, as noted at the beginning of this note, are *Portage Plastics Co. v. United States,*[57] *Shores Realty Co. v. United States,*[58] and *Amory Cotton Oil Co. v. United States.*[59] In *Portage,* the United States Court of Appeals for the Seventh Circuit became the first court to validate the regulation in question, while two separate fifth circuit panels in *Shores Realty* and *Amory* found the regulation invalid.

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53 *Id.,* n. 4. The proposal was quoted in part:

> Under the proposal the existence of any interest not designated as stock, which has neither voting rights nor rights to distributions beyond a fixed annual interest rate and a fixed amount upon redemption or payment, will not cause the corporation to be disqualified even if the interest is determined to be equity capital.

54 322 F. Supp. 1069 (N.D. Ala. 1971), *on remand from* 426 F.2d 218 (5th Cir. 1970), *vacating* 68-1 U.S. Tax Cas. 86,771 (N.D. Ala. 1968).

55 322 F. Supp. at 1072.

56 *Id.* at 1073.

57 470 F.2d 308 (7th Cir. 1972), *rev'g* 301 F. Supp. 684 (W.D. Wis. 1969).

58 468 F.2d 572 (5th Cir. 1972), *aff'g* 27 Am. Fed. Tax. R.2d 71-679 (S.D. Fla. 1971).

59 468 F.2d 1046 (5th Cir. 1972), *aff'g* 320 F. Supp. 951 (N.D. Miss. 1970).

A. *Portage Plastics Company v. United States*

In *Portage*, the district court did not follow the regulation.[60] Portage Plastics Company had issued notes to some nonshareholders as well as to shareholders[61] with the result that the corporation was very thinly capitalized. The district court found that these advances were actually contributions to capital.[62] The court found persuasive in this regard the fact that interest to be paid was to be a percentage of net profits, that the corporation had a high ratio of debt to equity, that there was no provision for acceleration of payment of principal in case of default in interest payments, and that the plastics business had been marginal, thereby rendering returns on investments rather speculative.[63]

However, the district court refused to find that the notes constituted a second class of stock.[64] From the legislative history, the court determined that the purpose of Subchapter S was to allow small businesses to select a form of organization without the necessity of taking into account major differences in tax consequences.[65] Further, it found that the primary reason for the one class of stock rule was to avoid administrative complexities which would arise in the allocation of earnings and losses among several classes of stockholders.[66] It also suggested that a second possible reason for the one class of stock rule was an attempt to limit Subchapter S to small corporations.[67] The court continued:

> It does not appear that the traditional debt-equity tests applied in other areas of tax litigation are relevant to the general purpose of Subchapter S or to the two conceivable purposes of the one class of stock requirement. . . .
>
> It must be determined whether a conclusion that the instruments given in exchange for the advances constitute a second class of stock *would serve the purposes of Subchapter S* in general and the one class of stock requirement in particular.
>
> It is clear that the plaintiff during the period in question was a small corporation, of the type that the Subchapter S provisions were intended to benefit.[68]

The court also found that none of the feared administrative complexities were present in the instant situation,[69] and accordingly upheld the Subchapter S election.[70]

The United States Court of Appeals for the Seventh Circuit, however, reversed over a strong dissent. The court agreed with the lower court, on the same grounds, that the instruments in question constituted contributions to capital rather than loans to the corporation.[71] The court, however, went on to say:

60 301 F. Supp. at 694.
61 *Id.* at 686.
62 *Id.* at 690.
63 *Id.* at 689-90.
64 *Id.* at 694.
65 *Id.* at 691.
66 *Id.*
67 *Id.* at 692.
68 *Id.* at 692-93 (citation and footnote omitted, emphasis added).
69 *Id.* at 693.
70 *Id.* at 694.
71 470 F.2d at 311-12.

> We would not hesitate, however, to add that having decided the instruments were not evidences of a loan to the corporation they must be some kind of evidence of equity in the corporation and not merely "contributions to capital," where the circumstances warrant such a conclusion. In other words, *we would not be reluctant to call these instruments "stock" as that is the term commonly used to designate an instrument which represents an interest in the equity of a corporation*. . . . [I]t is our opinion that once the initial judicial determination has been made, the law, as set forth by section 1371(a)(4) and Treasury Regulation § 1.1371-1(g) answers the second question. In other words, we are of the opinion that *there is no such thing as "non-stock equity,"* the creature of a conclusion that the evidences of a capital contribution are *not* stock, and, furthermore, we are of the opinion that Regulation § 1.1371-1(g) is a reasonable and consistent interpretation of section 1371(a)(4) when used properly.[72]

The court went on to express its opinion that the debt-equity question should be looked at in the Subchapter S context:

> [W]e feel it is a mistake to say that the "thin capitalization" doctrine has been used to make the determination for Subchapter S purposes; the true test used, as was used in this case, is a separate application of relevant factors which have sometimes been grouped together under the heading of the "thin capitalization" doctrine. In reality, these factors can and should be used independently to establish whether or not the holders of the obligations enjoy any rights or interest different from and in preference to the holders of the nominal (authorized common) stock. If there are these preferential rights or interests then the purported debt may be reclassified as equity, which in turn, according to Regulation § 1.1371-1(g) can be considered stock and, indeed, a *second class* of stock. In our opinion, this result dictated by the regulation in question, is thoroughly consistent with the statute and is not, in view of the purpose of the requirement, unreasonable or inconsistent.[73]

B. *Shores Realty Co., Inc. v. United States*

In *Shores Realty*, the district court, citing *Stinnett* and *H.R. Spinner*, had found that even if the non-pro rata advances here were not bona fide indebtedness, then "they were some form of surplus that is not a class of stock within the contemplation of 26 U.S.C. § 1371(a)(4)."[74] On appeal, the United States Court of Appeals for the Fifth Circuit, speaking through Judge Simpson, did not reach the question of whether these advances were capital advances rather than loans because it found that the debt-equity analysis was not applicable in the Subchapter S context:

> Nevertheless the fact remains that the underlying statute . . . does not speak in terms of "capital." It makes reference only to "stock." In addition, the legislative history of the "one class of stock" criterion does not reflect any legislative concern with the "debt versus equity" capitalization problem; that history appears to dwell exclusively upon possible conflicts of interest

72 *Id.* at 312 (emphasis added).
73 *Id.* at 315 (footnote omitted, emphasis in original).
74 27 Am. Fed. Tax R.2d at 71-681.

> between the holders of different classes of stock in a "small business corporation."
>
> . . . We conclude that the legislative use of the term "stock" foreclosed the Commissioner from granting or withholding from a taxpayer favorable Subchapter S income tax treatment on the basis of that taxpayer's capital structure (i.e., debt versus equity).[75]

The court also spoke to the proportionality criterion of Treasury Regulation 1.1371-1(g):

> [W]e find no support for the proposition that "disproportionality" was intended by Congress to transform what the principals to the corporation denominated debt obligations into preferred stock.[76]

In concluding, the court invalidated Treasury Regulation 1.1371-1(g) and gave the following recommendation:

> If these standards [debt-equity and proportionality] are to be employed in assessing the eligibility of corporate taxpayers for "small business corporation" Subchapter S treatment, Congress is the authoritative body to prescribe them.[77]

C. *Amory Cotton Oil Co. v. United States*

In *Amory Cotton Oil Co. v. United States*, the district court held that although non-pro rata advances were contributions to capital and not true loans,[78] they did not constitute a second class of stock.[79] The corporation therefore qualified for Subchapter S treatment.[80] In so holding, the court cited with approval *Gamman, Stinnett*, and the district court opinion in *Portage*, saying the holdings in these cases stated "the more reasonable rule."[81]

The United States Court of Appeals for the Fifth Circuit again affirmed, this time speaking through Judge Godbold. This panel, however, took a somewhat different stance than that of the *Shores Realty* panel, in that here the court found the debt-equity inquiry to be relevant:

> [W]e reject the concept that the debt-equity distinction has no relevance to the subchapter S corporation and that as a matter of law recharacterization of debt to equity may not be employed for the subchapter S corporation. Our primary guide must be the statute. The single [class of] stock requirement is in the statute. That requirement would be effectively repealed by judicial action if form were so allowed to control substance that what purports to be debt but according to objective criteria is equity cannot be treated as what it is. The Commissioner and the courts are not required to

75 468 F.2d at 577 (footnote omitted).
76 *Id.* at 577-78.
77 *Id.* at 578.
78 320 F. Supp. at 956.
79 *Id.* at 961.
80 *Id.*
81 *Id.* at 960.

> accept as conclusive the label of debt given by the corporation and those with whom it deals . . . .[82]

However, the court still took exception to the proportionality test:

> The IRS interpretation that investment in debt obligations must be pro rata to stock to avoid recharacterization tends to limit use of subchapter S to those businesses in which shareholders are able to make such pro rata investments. [Another] factor that bears consideration is the particular use of debt —whether in a specific instance it serves a purpose within the contemplation of subchapter S.[83]

The court also noted the opinion of the United States Court of Appeals for the Seventh Circuit in *Portage*[84] and disagreed with it:

> The view of the majority in *Portage* rests upon what is considered to be an imperative necessity for identity of rights and interests between holders of stock and holders of debt interests, which in turn rests upon the policy of avoiding difficulties of allocation of earnings and losses. This view takes the identity of interest which the court in *Gamman* found to be a saving factor, and elevates it to the status of *sine qua non*. It does so in face of the fact that proportionality of stock and debt holdings has repeatedly been rejected. . . . We cannot accept this focus upon a single policy which gives no room for consideration of Congress' recognition that subchapter S corporations will often have limited capital and must borrow, and its apparent intention that borrowing from stockholders may occur without causing loss of the special tax status. In addition, like the dissenting judge [in *Portage*], we do not accept the conceptualistic view that every contribution to the capital of a subchapter S corporation which is not authorized and issued stock must be a second class of stock within the meaning of § 1371(a)(4).[85]

Finally, the court said that the "true inquiry . . . is debt-versus-equity read together with the underpinnings of subchapter S and the rationale of the one class of stock requirement."[86] Accordingly, it found that Treasury Regulation 1.1371-1(g) did not look toward this inquiry and was invalid.[87]

IV. Resolution of the Conflict

With the fifth and seventh circuits in conflict as to the validity of Treasury Regulation 1.1371-1(g), and the ninth circuit likely to add its opinion soon,[88] the Supreme Court may be expected to settle the question.[89] Without reciting all

82 468 F.2d at 1050.
83 *Id.* at 1052 (footnotes omitted).
84 *Portage* had been decided on July 18, 1972. *Shores Realty* and *Amory* were both decided on October 24, 1972.
85 468 F.2d at 1053-54.
86 *Id.* at 1054.
87 *Id.*
88 As previously noted (notes 42 and 47) both *H.R. Spinner Corp.* and *James L. Stinnett, Jr.* are being appealed to the United States Court of Appeals for the Ninth Circuit.
89 Supreme Court Rule 19(e)(b) states that a split among the circuits on an issue is one factor that the Supreme Court should consider in exercising its discretion in granting or denying certiorari. U.S. Sup. Ct. Rule 19(1)(b), 28 U.S.C. (1970).

the arguments already made by the lower courts, the wiser holding for the Supreme Court to make would be to affirm *Shores Realty* and *Amory* and invalidate Treasury Regulation 1.1371-1(g). Since a Subchapter S corporation derives no tax benefit from thin capitalization, and since no great administrative complexities are introduced by the fact of thin capitalization, and furthermore, since § 1376 of the Internal Revenue Code anticipates stockholder indebtedness,[90] it is clearly consistent with the intent of the Congress to permit small corporations to be thinly capitalized without losing their favorable Subchapter S status.

The Treasury Department could obviously settle the matter by amending its regulation to make it consistent with the proposal it made to Congress in 1969.[91] However, since the IRS has continued to diligently litigate these cases, such an amendment does not appear to be forthcoming.

Congress may be the ultimate body to which we must look. By specifically amending the one class of stock rule so that contributions to capital by shareholders in the form of loans (what the *Portage* opinion calls "non-stock equity"[92]) would not constitute a second class of stock, or simply by defining what constitutes a second class of stock for the purposes of Subchapter S, the problem can be simply and clearly resolved.

In any event, it is imperative that either the Supreme Court, the Treasury Department, or the Congress act in this regard. With the circuits in conflict as they are, planning and counselling on this matter are at best risky and the consequences of wrong advice resulting in retroactive termination of Subchapter S status are harsh and unnecessary.*

Paul F. Jones

90 INT. REV. CODE of 1954, § 1376, provides in part:

> (b)(2) REDUCTION IN BASIS OF INDEBTEDNESS.—The basis of any indebtedness of an electing small business corporation to a shareholder of such a corporation shall be reduced . . . by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year. . . .

91 See note 53, *supra*.

92 470 F.2d at 312.

* Subsequent to the composition of this note the United States Court of Appeals for the Seventh Circuit, sitting *en banc*, reversed the earlier decision by a panel of that circuit, thus affirming the district court's decision for the taxpayer in Portage Plastics Co. v. United States, 31 Am. Fed. Tax R.2d 864 (1973). The full court found the thin capitalization approach not applicable:

> [W]e conclude that the traditional thin capitalization doctrine tests for determining whether a particular loan should be treated as an equity contribution in order to prevent improper tax avoidance in other contexts are not suitable for determining whether a purported loan constitutes a second class of stock within the meaning of Section 1371(a)(4). *Id.* at 867.

Reasoning along the lines of the dissent in the panel's earlier opinion, the full court also found Treasury Regulation 1.1371-1(g) invalid to the extent to which it called for a contrary result. *Id.* at 869.

While this leaves the Fifth and Seventh Circuits in agreement, the issue is not dead. The Commissioner has not acquiesced in any of these cases, and the Ninth Circuit still has *Stinnett* and *H.R. Spinner* before it. If the Ninth Circuit does decide for the taxpayer, the Commissioner can still be expected to seek different results in the remaining circuits, and it is still likely that the Supreme Court, unless Congress acts in the meantime, will be the final arbiter in the matter. [Ed.]