COMMENTS

DISPUTED USES OF DEBT BY SUBCHAPTER S CORPORATIONS

There has been considerable controversy over interpretation of the requirement that there be only one class of stock in a subchapter S corporation. It is a simple matter to draft instruments which conform literally with the statutory requirement. However, in certain situations, typically involving ostensible debt instruments, the Commissioner has challenged the formal designation, arguing that the facts indicate that for tax purposes there are at least two classes of stock. This Note will examine, primarily in relation to the one class requirement, the question whether for tax purposes a given instrument is to be treated as debt or stock. More specifically, the following will be considered: first, application of the so-called "thin capitalization" doctrine to find purported debt in fact to be a disqualifying second class of stock; second, the soundness of an alternative approach recently suggested by the Tax Court which would treat disputed advances as a non-disqualifying contribution to the existing class of stock; third, the rationale of the one class requirement applies only to stock which is issued and outstanding. Consequently, treasury stock and unissued stock of a second class will not cause disqualification. Treas. Reg. § 1.1371-1(g) (1959).


The thin capitalization doctrine is a shorthand reference to the approach developed in many cases which have found that a corporation was inadequately capitalized and that ostensible debt instruments were, for tax purposes, actually stock. See, e.g., Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); Bruce v. Knox, 180 F. Supp. 907 (D. Minn. 1960); Dobkin v. Commissioner, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951). See generally Bittker, Thin Capitalization: Some Current Questions, 10 U. Fla. L. Rev. 25 (1957);

1 See, e.g., Caplin, Subchapter S and Its Effect on the Capitalization of Corporations, 13 Vand. L. Rev. 185 (1959); Manly, Election under Subchapter S can eliminate thin-incorporation problem, 9 J. Taxation 322 (1958); Salkin, What the courts and the Commissioner have been saying about Subchapter S, 24 J. Taxation 116 (1966).

2 INT. REV. CODE OF 1954, § 1371 (a): "For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which . . . does not . . . have more than one class of stock."

This requirement applies only to stock which is issued and outstanding. Consequently, treasury stock and unissued stock of a second class will not cause disqualification. Treas. Reg. § 1.1371-1(g) (1959).


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class requirement; fourth, a suggested approach to resolving contro-
versies involving disputed debt instruments of subchapter S corpo-
rations.

I. Application of the Thin Capitalization
Doctrine to Subchapter S Corporations

The Code itself provides no explanation or reason for the one class
requirement and the congressional reports on the 1958 Technical
Amendments Act are equally unrevealing. Lacking specific guide-
lines, the Commissioner has adopted a restrictive interpretation.
Regulation 1.1371-1(g) provides that if outstanding shares do not
provide identical rights and interests in the control, profits, and assets
of the corporation, there is more than one class of stock. Differences in
voting rights, dividend rights, or liquidation preferences will be dis-
qualifying. Specifically referring to debt, the regulation’s final sentence
states, “If an instrument purporting to be a debt obligation is actually
stock, it will constitute a second class of stock.” This statement has
generally been interpreted as incorporating the thin capitalization
doctrine into subchapter S.

Any discussion of the thin capitalization doctrine is complicated
by the fact that the doctrine itself cannot be summarized succinctly. As
used hereafter, “thin capitalization” denotes a capital structure in
which the ratio of debt to stock is weighted heavily in favor of debt
instruments. Normally such capital structures are used, generally by
closely-held corporations with the shareholders holding the debt instru-
m ents, because of substantial tax benefits offered by debt. When it is

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6 The Senate report simply states that the corporation “may not have more
7 Treas. Reg. § 1.1371-1(g) (1959).
8 Ibid.
9 See Caplin, Subchapter S and Its Effect on the Capitalization of Corporations,
13 VAND. L. REV. 185 (1959); Hrousoff, Election, Operation and Termination of a
Subchapter S Corporation, 11 VILL. L. REV. 1, 9 (1965). The possibility of applying
the thin capitalization doctrine to subchapter S corporations was recognized even before
the regulations appeared. See Anthoine, Federal Tax Legislation of 1958: The Cor-
10 It is not possible to state mechanically the point at which the ratio may
appear excessive. What is excessive in one industry may be normal in another.
See Bittker, supra note 4, at 28.
11 As outlined by Professor Bittker, debt may be used for any of the following
reasons:

1. The corporation is entitled to deduct any interest paid on indebtedness,
whereas dividends, being considered a distribution of profits, are not similarly
deductible.

2. Payment at maturity may constitute a “reasonable business need” under
§ 533(a) which helps to avoid the accumulated earnings tax of § 531.
clear that the amount of “debt” used is dictated solely by tax considerations, courts have applied the thin capitalization doctrine and disregarded the debt designation. However, because it is still true that even a fairly high ratio may be justified by business considerations, the courts have considered a number of factors relevant to determination of whether a thin capital structure is legitimate.

Obviously, a prime factor is the particular debt/equity ratio involved, and the early cases often seem to make this factor determinative. Later decisions began to consider additional factors such as whether the instruments were held pro rata by the shareholders, or whether the funds represented by the debt were used to purchase assets essential to the formation of the business. More recent cases have suggested that the issue turns on subjective factors, particularly the holder’s “intent” to treat his debt claims as would any other creditor. If the test is solely subjective, it may be a misnomer to use the label “thin capitalization doctrine” because the requisite intent may not be related to the “thinness” of the debt/equity ratio. However, in practice

3. Payment of debt will ordinarily either be tax-free to the recipient or produce capital gain whereas stock redemptions are often taxed as dividends.
4. Debt may be transferred without any loss of control.
5. An initial issue of debt is without tax consequences whereas a later issue will ordinarily be taxed as a dividend.
6. Debt may sometimes give ordinary loss treatment on worthlessness, whereas worthlessness on stock generally produces a capital loss.

See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 111-12 (1965). As will be seen, under subchapter S the reasons for using debt are considerably different. See note 27 infra and accompanying text.


See Dobkin v. Commissioner, 15 T.C. 31 (1950), aff’d per curiam, 192 F.2d 392 (2d Cir. 1951); Note, Thin Capitalization and Tax Avoidance, 55 COLUM. L. REV. 1054, 1061 n.51 (1955) and cases cited therein. There have been attempts to determine what is a “safe” ratio. Based on Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944), aff’d sub nom. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), it was thought that 4:1 marked the boundary of the safe area. SURREY & WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 1195 (1962). For discussion of the 4:1 ratio test, see Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17TH INST. ON FED. TAX 771, 783-84 (1959).

1432 Broadway Corp. v. Commissioner, 4 T.C. 1158 (1945), aff’d per curiam, 160 F.2d 885 (2d Cir. 1947). In Leach Corp., 30 T.C. 563 (1958), the absence of pro rata holding of debt and equity was emphasized. It has been pointed out that only in the case of pro rata holding is there a maximum incentive to issue debt. Goldstein, supra note 4, at 6-7. However, even if holding is not pro rata, the court may classify the debt as stock. Reed v. Commissioner, 242 F.2d 334 (2d Cir. 1957).

Schnitzer v. Commissioner, 13 T.C. 43 (1949), aff’d per curiam 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951). The validity of regarding this as an important factor has been questioned. See BITTKER, op. cit. supra note 11, at 116.

The leading case is Goodyng Amusement Co. v. Commissioner, 23 T.C. 408 (1954), aff’d, 236 F.2d 159 (6th Cir. 1956).
the Commissioner will have no reason to dispute a low ratio.\textsuperscript{18} Furthermore, courts will probably continue to consider the ratio when seeking to establish a taxpayer's true intent.\textsuperscript{19} Because other tests will not be reached until a high ratio is shown, the following discussion will focus on tax consequences of establishing a high debt/equity ratio in a subchapter S corporation. In two cases in which debt/equity ratios of subchapter S corporations have been questioned, the courts have applied the thin capitalization doctrine.

In \textit{Henderson v. United States},\textsuperscript{20} the corporation made a subchapter S election at its inception. The taxpayer-shareholder and other shareholders made pro rata advances during the second year of operation despite continuing losses. The Commissioner disallowed loss deductions taken by the shareholder. The district court held that the evidence established that the advances were capital investments and constituted a second class of stock, thereby disqualifying the corporation under subchapter S. The court, in holding that the advances were in fact equity, cited prior cases in which the debt-or-equity issue had been decided.\textsuperscript{21} These cases indicated that, in general, the answer depended on an overall evaluation of the true nature of the relationship created by the advance. Relevant factors were whether the advances were pro rata, or essential to the inception of the business and whether there was adequate security given or any attempt to enforce the obligations.

The court's reliance on prior authority implies that although all the cited cases involved normal corporate tax treatment,\textsuperscript{22} the same tests should be applied when a subchapter S corporation is thinly capitalized. The conclusion reached by the \textit{Henderson} court is by no means inevitable because of substantial tax differences between subchapter S corporations.
and normal corporate tax provisions. For example, under subchapter S, the benefit of a deduction for interest payments is absent because the corporation pays no taxes and the shareholder reports both interest and dividend payments as ordinary income. In Catalina Homes, Inc., the petitioner made this point in arguing against the use of the thin capitalization doctrine.

In Catalina, the subchapter S corporation made profits for the year in question and distributed them without declaring a formal dividend. The corporation had a high debt/equity ratio and the Commissioner determined that the purported debt was a disqualifying second class of stock. The taxpayer argued that the advances should be treated as loans because the shareholders would pay the same total tax whether the distributions were labelled interest or dividends. The court conceded the taxpayer's point but still applied the doctrine, stating that the interest deduction was not the only advantage which followed from debt and noting several advantages attendant to thin capitalization. The advantages indicated by the court were all drawn from normal corporate taxation and do not offer identical benefits under subchapter S. Thus, it is pertinent to ask just what are the advantages of debt under subchapter S provisions?

A relatively clear instance arises when current earnings and profits exceed taxable income. Ordinarily, of course, a subchapter S corporation's earnings and profits account for a given year will be zero because the shareholders will have been taxed on both actual distribu-

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23 Manly, supra note 1, at 323.
24 IRC. Rev. Code of 1954, § 1372, provides that "any small business corporation may elect ... not to be subject to the taxes imposed by this chapter."
25 IRC. Rev. Code of 1954, § 61(a). Because subchapter S eliminates "double taxation" of corporate income, § 1375(b) denies the dividends received exclusion of § 116 and the dividends received credit of § 34.
27 The court pointed to the following issues: (1) whether distributions are deductible interest payments or dividends; (2) whether a corporate payment is deductible as a cost of goods sold or is a dividend; (3) whether a corporation realizes income on cancellation of shareholder-held debt; (4) whether an advance qualifies as a loan for purposes of taking a bad debt deduction; (5) whether repayment of an advance is a tax-free repayment of a loan or a dividend.
Under subchapter S, the interest deduction issue, (1), is moot. See note 24 supra and accompanying text. There is no need to seek bad debt deductions, (4), because losses are taken directly by the shareholder. See SURREY & WARREN, op. cit. supra note 14, at 1189. Under subchapter S the loan repayment issue seems to present the only significant problem. See text discussion accompanying notes 29-62 infra.
28 Ibid.
29 The effect of an income item on earnings and profits does not depend on whether it is taxable to the corporation. For example, tax-exempt income increases earnings and profits. Realized though unrecognized losses reduce earnings and profits. Intercorporate dividend deductions and percentage depletion do not reduce earnings and profits. See Andrews, "Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends, 69 Harv. L. Rev. 1403, 1450 (1956).
tions and their share of the undistributed taxable income, and earnings and profits are reduced by the amount taxed to the shareholders. However, taxable income may not be computed in the same manner as earnings and profits, as, for example, when the corporation receives tax-exempt income or utilizes percentage depletion. In such cases, the corporation may have current earnings and profits in excess of taxable income. If not distributed to the shareholder, neither the corporation nor the shareholder would be taxed on the excess. If distributed, the amounts would be taxed to the shareholder as dividends because the corporation is not treated as a conduit. The shareholder may, however, be able to take this excess out tax-free as a return of capital by paying off debt, whereas stock redemptions run the risk of being dividends. The same reasoning applies if the corporation had accumulated earnings and profits in a prior year, whether as a normal or subchapter S corporation.

Current or accumulated earnings and profits are of particular relevance in other situations. As noted, the shareholder is taxed both on actual distributions and on any remaining undistributed taxable in-

\[\text{INT. REV. CODE OF 1954, } \S \text{ 1373(b), provides that the shareholder "shall include in his gross income ... the amount he would have received as a dividend, if ... there had been distributed ... an amount equal to the corporation's undistributed taxable income."} \]

\[\text{Section 1373(c) provides that "the term 'undistributed taxable income' means taxable income ... minus the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a) (2)."} \]

\[\text{Finally, } \S \text{ 1377(a) provides that "the accumulated earnings and profits of an electing small business corporation ... shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of the shareholders ..."} \]

\[\text{\textsuperscript{20} INT. REV. CODE OF 1954, } \S \text{ 1375(a), provides that the shareholder may treat as capital gain his pro rata share of the corporation's long term capital gain.} \]

\[\text{\textsuperscript{21} Assume } A \text{ is the sole shareholder of } X, \text{ a subchapter S corporation, which in its first year (1960) has } $50,000 \text{ taxable income and } $10,000 \text{ tax-exempt income. If no distribution is made, } A \text{ will be taxed on } $50,000, \text{ previously taxed income (PTI) will be } $50,000, \text{ and } X's \text{ earnings and profits (E & P) at year's end will be } $10,000. \text{ If } $60,000 \text{ is distributed, } A \text{ will be taxed on } $60,000. \text{ If, however, } A \text{ held a } $10,000 \text{ debt instrument, } X \text{ could distribute } $10,000 \text{ to pay off the debt, } A \text{ receiving a tax-free return of capital under } \S \text{ 1232. The remaining } $50,000 \text{ would be reported by } A \text{ as ordinary taxable income, whether distributed or not, and } X's \text{ E & P would remain at } $10,000.} \]

\[\text{In this and subsequent footnotes, examples of the situations described in text are given. Several of the examples were suggested by situations presented in Moore & Sorlien, } \textit{Adventures in Subchapter S and Section 1244,} 14 \textit{TAX L. REV.} 453 \text{ (1959). The regulations provide examples which demonstrate mechanics of taxing distributions. See Treas. Reg. } \S \text{ 1.1373(g) (1959).} \]

\[\text{\textsuperscript{24} Assume the preceding hypothetical altered as follows: The corporation had accumulated } $10,000 \text{ earnings and profits prior to making a subchapter S election in 1960. During 1960, the corporation has } $50,000 \text{ taxable income, but wishes to distribute } $60,000. \text{ Dividend treatment on } $10,000 \text{ may be avoided by repayment of } $10,000 \text{ of debt.} \]
come. In subsequent years, tax-free withdrawals of cash may generally be made from this previously-taxed-income (PTI) account. When earnings and profits are present, some method is necessary to earmark the source of a particular distribution. The regulations provide that cash distributions from PTI may be distributed tax-free notwithstanding the existence of accumulated earnings and profits. However, a distribution cannot be made from PTI until all earnings and profits of the current year have been exhausted. To help illustrate the difficulties this may cause, assume the shareholder has a PTI account from a prior year. In the current year, the corporation, due to receipt of tax-free life insurance proceeds, has an excess of earnings and profits over taxable income. If the shareholder removes the entire amount of the earnings in the form of cash, he will be forced to pay dividend tax on the excess. Only after the excess is exhausted will he be able to earmark the funds as coming from PTI. Of course, if the tax-free income is non-recurring and substantial in amount, the shareholder may prefer to have the distribution made in the following year because the excess will then be included in accumulated, rather than current, earnings and profits and would thereby avoid the dangers of dividend taxation. But if the shareholder needs the funds, they could be removed by repayment of a debt even in the year the excess is received, again avoiding dangers involved in redemption of stock.

Distributions in kind raise similar but even more serious difficulties. The regulations provide that current earnings and profits are first allocable to actual distributions of money and then ratably to constructive dividends and distributions in kind and finally to any distribution in exchange for stock. If current earnings and profits exceed taxable in-

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35 See note 30 supra.
36 INT. REV. CODE of 1954, § 1375(d) (1), provides that the corporation: may distribute . . . to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall . . . be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.
38 Ibid.
39 Assume the hypothetical in note 33 supra. In 1961, the corporation again has $50,000 taxable income and $10,000 tax-exempt income. If $60,000 is distributed, A will be taxed on $60,000. This will be true even if no distributions were made in 1960 and A had a $50,000 PTI account in 1961.
40 Continuing with the hypothetical in note 39 supra, if X has made no distributions in 1960 and 1961, A will have $100,000 PTI. In 1962 X again has taxable income of $50,000 and distributes $70,000. It would be possible to earmark $20,000 as coming from PTI, despite the presence of $20,000 accumulated earnings and profits.
41 This is the "three tier" system. Treas. Reg. § 1.1373-1(e) provides:
come, and if the value of a distribution in kind likewise exceeds taxable income, the excess earnings and profits will require dividend treatment. This, of course, is identical with the consequences of a cash distribution. However, the regulations further provide that only cash distributions may qualify as distributions from the PTI account. Thus, if the distribution in kind would be covered by PTI, but there are current or accumulated earnings and profits, the distribution will be treated as a dividend. It would no longer be possible to wait a year, as recommended for cash distributions, and then designate the distribution as made from PTI. It would, however, be possible to use the property involved to pay off or reduce shareholder-held-debt without subjecting the shareholder to dividend treatment.

The foregoing illustrates only one of several difficulties with the PTI account. The account is personal to the shareholder and disappears if he ceases to be a shareholder, whether by transfer or death. Moreover, if the election is terminated, the account is wiped out and distributions will be from earnings and profits until exhausted. Further, the account is reduced by both prior and subsequent losses which have been passed through to the shareholder. For these reasons, it may appear desirable to have the corporation distribute all of its earnings in the current year. If these funds are needed in the business, as is usual with a new enterprise, the shareholder may return

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(1) Earnings and profits of the taxable year are first allocated to the actual distributions of money . . . . (2) The excess of such earnings and profits over such actual distributions of money is allocated ratably to the constructive distribution of undistributed taxable income and actual distributions of property other than money. . . . (3) The remainder of such earnings and profits is available to be allocated to distributions in exchange for stock . . . .

Assume the facts of the hypothetical in note 33 supra. In 1960 X distributes land worth $60,000, instead of cash. The land has a basis of $10,000. The current earnings and profits are $60,000 and are allocated ratably between the undistributed taxable income of $50,000 and the distribution in kind, valued at $60,000. Thus, $27,273 of undistributed taxable income will be a dividend and $32,727 of the distribution in kind will likewise be treated as a dividend. A pays dividend taxes on $60,000, just as he would if $60,000 cash had been distributed.

Assume X has $10,000 accumulated earnings and profits prior to making a subchapter S election in 1960. In 1960, X has taxable income of $50,000 and makes no distributions. In 1961, X has no taxable income but distributes land worth $50,000 with a basis of $10,000. Although A has $50,000 of PTI, he pays dividend taxes on $10,000. However, A could remove the property tax-free by using it to repay a debt.

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Under Int. Rev. Code of 1954, § 1375(d) (1), only "an electing small business corporation" may make distributions from PTI. If the corporation is disqualified but later makes another election, the original PTI account is not restored. See Treas. Reg. § 1.1375-4(d) (2) (1959).

See Moore & Sorlien, supra note 33, at 472; Anthoine, supra note 9, at 1163-65.
them to the corporation in the form of a capital contribution or indebtedness. If this is done solely to avoid the dangers to the PTI account, the Commissioner might argue that, regardless of the form of the advances, the transaction was a "sham" and thus the PTI account remained unchanged. Alternatively, it has been suggested that, if the advances are in the form of debt, the Commissioner could invoke the thin capitalization doctrine. This suggestion should not be accepted without some analysis of the situations in which debt might offer advantages.

If the corporation has no accumulated earnings and profits and if current earnings and profits and taxable income are identical, then the funds withdrawn from PTI could be returned by the shareholder as either a loan or a capital contribution, because without earnings and profits, a stock redemption would be identical to repayment of a debt. Thus, it would be advantageous to use debt rather than stock only when the corporation had accumulated or excess current earnings.

Similar reasoning applies if the corporation is disqualified. If, at the time the corporation terminates its subchapter S status, there are no accumulated earnings, the corporation immediately could redeem stock or repay debt with identical results.

The treatment of losses passed through to the shareholders presents another opportunity for manipulating advances so as to derive a tax benefit. The shareholder may deduct corporate losses from his personal income only to the extent of his adjusted basis in his share of the

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50 See SURREY & WARREN, op. cit. supra note 14, at 1461. It has also been suggested that the transaction might be regarded as the distribution of a corporate obligation rather than money. BITTKE, op. cit. supra note 11, at 417.

51 See Moore & Sorlien, supra note 33, at 473; Goodson, Scheifly & Thompson, Planning with Subchapter S in 1960, U. So. Calif. 12th Tax Inst. 165, 170 (1960). It should be noted that the writers, when referring to the use of the "thin capitalization doctrine" in such situations, may be using the term simply to indicate that certain uses of debt may be subject to challenge. However, the danger of this use of the term is that it makes the normal thin capitalization cases appear to be direct precedents, obscuring analysis of precisely what uses, if any, of debt are involved.

52 Assume X has $50,000 taxable income in 1962, and no accumulated earnings and profits. A has $25,000 PTI from 1961. X distributes $75,000 in 1962. A pays dividend taxes on $50,000 and receives $25,000 tax-free as a distribution from PTI. A returns $25,000 to X receiving stock. In 1963, X again has $50,000 taxable income, and redeems $25,000 of A's stock. In 1963, A will be taxed on $50,000 as actual or constructive dividends and earnings and profits will thereby be reduced to zero. Because there are no earnings and profits, $25,000 will be a tax-free return of capital.

53 It is assumed that the shareholder's basis in his stock has not been reduced by losses passed through to him. For discussion of the impact of losses, see note 56 infra and accompanying text.

54 Failure to meet any one of the qualification requirements automatically terminates the election. Thus, for example, a transfer to an eleventh shareholder or to
stock and debt of the corporation.\textsuperscript{55} If losses exceed this basis, the excess is wasted because no carryover is allowed. Thus, if the shareholder's basis has been reduced to zero because of prior losses and he wishes to utilize current losses, he could advance funds sufficient to cover the loss. In the following year the funds could be returned. The effect of this transaction would be to provide an ordinary loss in the current year at the cost of a capital gain in the next year.\textsuperscript{56} As with PTI withdrawals followed by returns, the Commissioner could attack such a transaction as a "sham" whose tax consequences should be disregarded.\textsuperscript{67} But if the advance is in the form of debt, and the use of debt is attacked under the thin capitalization doctrine, only the existence of accumulated earnings would make it more advantageous to use debt rather than stock.\textsuperscript{68}

A more sophisticated method for utilizing losses might be devised. Assume the initial capital structure involves a high debt/equity ratio with the shareholder holding all the instruments. The corporation suffers losses which the shareholder deducts from his personal income, reducing his basis in stock and then in debt.\textsuperscript{69} The shareholder advances additional funds evidenced by stock instruments. The stock is qualified under section 1244 as small business stock.\textsuperscript{70}

\begin{itemize}
\item \textsuperscript{55} See Treas. Reg. § 1.1372-4(b) (3) (1959). Voluntary revocation is provided for in Int. Rev. Code of 1954, § 1372(e) (2) and requires unanimous consent by the shareholders no later than the end of the first month of the corporation's taxable year. The ease of arranging for a disqualification may substantially nullify the procedure required by § 1372(e) (2). See BITTKER, op. cit. supra note 11, at 403.
\item \textsuperscript{56} Int. Rev. Code of 1954, § 1374(c) (2). By expressly allowing the shareholder to take losses up to the basis of debt which he holds, that provision, along with § 1376(b) (2), makes it clear that at least some shareholder-held debt is permissible under subchapter S. See Salkin, \textit{What the courts and the Commissioner have been saying about Subchapter S}, 24 J. Taxation 116, 117 (1966).
\item \textsuperscript{57} Assume \(A\) has a total investment in \(X\) of $100,000. In its first year, 1960, \(X\) loses $100,000 which \(A\) deducts from his personal gross income in accordance with § 1374, thereby reducing his basis in both his stock and debt to zero. In 1961, it becomes apparent that \(X\) will lose an additional $25,000. \(A\) advances $25,000 in the form of debt, and thus can deduct $25,000 as an ordinary loss from his gross income. \(A\)'s basis in the new debt is reduced to zero. In 1962, \(X\) repays the debt, giving \(A\) a $25,000 capital gain. The same result would following if \(A\) advanced the $25,000 in the form of stock.
\item \textsuperscript{58} Roughly, Int. Rev. Code of 1954, § 1244, allows an individual to deduct any loss
\end{itemize}
are used to pay off the debt instruments held by the shareholder in his capacity as a creditor. This will result in a capital gain equal to the amount of the difference between the basis of the debt as reduced by the loss deduction, and the face amount of the debt instrument. The corporation then goes bankrupt, entitling the shareholder to a section 1244 deduction. The sum effect is two ordinary loss deductions and a single capital gain. Despite technical compliance with Code provisions, it would seem difficult to show such a transaction was not solely tax motivated.

II. THE Gaman Solution

The foregoing illustrates situations where there may or may not be advantages to debt in a subchapter S corporation. The examples are not all-inclusive but they demonstrate that most of the advantages of debt arise when the corporation has accumulated earnings and profits or when there is an excess of current earnings and profits over taxable income. While it is true that there are occasions when debt may be used to special advantage, in general, the benefits do not appear as great as those encountered under normal tax treatment. Moreover, it would seem that most of the benefits could be derived within the range of a safe debt/equity ratio. Thus, application of the thin capitalization doctrine in all cases where a subchapter S corporation has a high ratio seems inappropriate. Furthermore, the penalties may be much more severe. Not only is an actual or potential tax benefit lost, but also under the regulations disqualification occurs and the advantages of subchapter S status are lost. These factors may suggest rejection of the thin capitalization doctrine under subchapter S.

Before weighing the merits of this approach, an alternative solution to the problem must be considered. Disqualification depends upon the existence of a second class of stock, not simply on finding an instru-
ment is stock rather than debt. As noted, the regulations attempt to foreclose the issue by stating that debt found to be actually stock "will constitute a second class of stock." This conclusion may be sound as a practical matter, but it is not logically necessary. Thus, it has been argued that, even if an advance is in fact stock, it should be held to constitute merely a contribution of capital to the existing class of stock. This line of reasoning was employed in a recent Tax Court decision, *W. C. Gamman*, by seven of the ten majority judges.

The corporation made a subchapter S election in 1961 after several years of unsuccessful operations. The shareholders-taxpayers had made advances over several years, the capital structure by 1962 being about 240,000 dollars of debt evidenced by six per cent demand notes and 400 dollars of stock. No interest had ever been paid on the notes and no attempt had been made to collect the principal. The Commissioner disallowed loss deductions taken by the shareholder on the ground that the purported debt was a disqualifying second class of stock.

The Tax Court held for the taxpayer but there was no majority agreement on the proper rationale for reaching the result. Judge Drennen, joined by four other judges, found that the advances were in fact risk capital rather than bona fide debt, but that the advances did not constitute a disqualifying second class of stock. Judge Dawson, joined by Judge Hoyt, substantially agreed with this conclusion, emphasizing the harshness of the Commissioner's interpretation. Concurring in the result, Judge Withey, joined by two other judges, concluded that the advances were not risk capital at all but were true debt and thus, no question arose as to whether they constituted a second class of stock. Finally, in a five judge dissent, Judge Raun, accepting the premise that the advances were risk capital, argued that the terms of the notes differed from the terms of the stock and thus the instruments were a second class of stock.

Judge Drennen's opinion dealt first with the Commissioner's reliance on regulation 1.1371-1(g). Judge Drennen could find nothing in the statute or the legislative history requiring that debt found in fact to be stock must necessarily be a second class of stock, and thus found the regulation invalid. Considering the status of the advances more gener-

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64 See note 8 supra and accompanying text.
65 See Manly, Election under subchapter S can eliminate thin-incorporation problem, 9 J. TAXATION 322, 323 n. 2 (1988).
67 See note 8 supra and accompanying text.
ally, he concluded that the advances were placed at the risk of the business and were not true debt. Since this conclusion was reached by disregarding the explicit terms of the notes, he decided that the terms should be disregarded altogether so that the advances were simply contributions to the existing common stock. Buttressing this conclusion was evidence that the taxpayers had treated the advances as they had stock, so that in reality, no differences existed in the rights or interests of each. The opinion ends by distinguishing *Henderson* and *Catalina*, both of which reached a contrary result, by saying that both had accepted the regulation itself without inquiry and thus were not binding authority as to its validity.

Judge Raum's dissent rejected the conclusion that if the advances constituted stock, they need not be a second class of stock. That the taxpayers did not intend to enforce the notes did not mean that they could not legally do so at some later time when the corporation had sufficient funds.

It is apparent that the conflict between the opinions turns on the proper effect to be given to the terms of the instruments. In a sense, the difference is in the breadth of the approach to the problem: Judge Drennen expressly restricted himself to the facts of the case before him and did not speculate on how the terms might later be enforced; Judge Raum preferred a more sweeping approach.

Limited to the facts of the case, the result appears equitable. The advances were pro rata, the same persons held both the notes and the stock, and there was no apparent tax benefit derived from using debt rather than stock during the years in question. With the corporation losing money it might be argued that the taxpayers would have a favorable position as creditors in the event of bankruptcy. However, the taxpayers had agreed to subordinate their claims, and in any event, bankruptcy courts would probably subordinate shareholder-creditors to others when capitalization was as thin as in *Gamman*. The tax benefit which the Commissioner sought to disallow was the

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68 The continuing advances to the corporation may have enabled the taxpayers to utilize losses which would otherwise be unavailable because their basis in stock and debt had previously been reduced to zero. This possibility was not mentioned by the court. The Commissioner did argue that losses coupled with debt instruments presented possibilities for manipulation, but the argument was not related to the facts of the case. Brief for Respondent, p. 25. In any event, it appears that the losses would have been available to the taxpayers regardless of the form of the advances because the corporation lost money from its inception. See the example in note 56 supra.


deduction of corporate losses, a benefit flowing from subchapter S status, not from a thin capital structure. Disqualification in such circumstances seems a harsh result. Nonetheless, closer analysis reveals that although the result in _Gamman_ is equitable, there are flaws in the logic of finding the advances a mere contribution to the existing class of stock.

In _Gamman_, as in the typical thin capitalization case, the disputed debt instruments were held pro rata by the shareholders. Furthermore, all of the shareholders treated the debt in the same manner. However, there seems to be no reason why one of the shareholders could not insist on enforcing the terms of the instrument. Under state law the instruments apparently would remain debt instruments. For tax purposes they could be treated as stock but they would seem to be equivalent to preferred stock. Similar considerations apply if, instead of holding the notes themselves, the shareholders transfer them to a third party. Hypothesizing from _Gamman_, the new holder would be entitled to six per cent interest, the right to payment on demand, and probably liquidation preference. The normal thin capitalization cases support the conclusion that transfers of purported debt instruments held to be stock are transfers of preferred stock.

The transfer of disputed notes at least theoretically may run afoul of other requirements of subchapter S. If the notes are found to be stock, then the holder presumably would be counted as a shareholder with reference to the limitation of a total of ten shareholders. Similarly, an even more drastic effect would be that the "shareholder" would not have consented to the election. In these cases, the terms of the notes would be immaterial. Thus, a transfer of notes found to be stock might disqualify the corporation even if the terms were identical with those of the original stock. Once it is accepted that stock classification implies preferred stock classification, it is clear that _Gamman_ disregards the plain statutory requirement of a single class of stock.

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71 See Judge Dawson's concurring opinion, 46 T.C.—, No. 1, CCH TAX CT. REP., decision 27,900 at 2216 (1966).
72 BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 115 (1965).
73 See generally BITTKER, op. cit. supra note 72, at 406.
74 See Anthoine, Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment, 58 COLUM. L. REV. 1146, 1152 (1958); Goodson, Scheifly & Thompson, supra note 51, at 171.
76 IRC. REV. CODE OF 1954, § 1372(a), provides that the election is valid only if all persons who are shareholders on or before the first day of the first taxable year consent to the election.
Judicial refusal to give literal effect to statutory language is not a novel nor necessarily unsound practice, but it is an exception which should be made only when literal application of the language contradicts the broad statutory purpose and no other solution is possible.

If this criticism of *Gamman* is accurate, then it is necessary to return to the initial issue of whether a disputed advance should be treated as stock or debt. Although there are occasions when debt offers special advantages under subchapter S, in general, the benefits of a high debt/equity ratio are not as great as under normal tax treatment. What is needed then is a means of preventing abuses in the occasional situations without at the same time imposing unwarranted penalties in situations where abuse is at best only remotely possible. The thin capitalization doctrine, as it has been developed in normal situations, cannot be uncritically read into subchapter S. *Gamman* appears analytically unsound. Thus, a new approach based upon the special features of subchapter S should be developed.

### III. The Rationale for the One Class Requirement

A preliminary step is to ascertain, if possible, the rationale behind the one class requirement. Unfortunately the legislative history is meager. The 1958 Senate Report on subchapter S says no more than that to qualify as a "small business corporation," the corporation could not "have more than one class of stock." Subchapter S, however, represented the culmination of many suggestions to permit shareholders of closely held corporations to be taxed basically as partnerships. In 1954, when considering a provision similar to subchapter S, the reports discussed the one class requirement in somewhat greater detail. The explanation given was that "if this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications," and further, "In order to avoid possible complications in the taxation of preferred stock dividends not..."
earned in the year distributed, only corporations having one class of stock outstanding may qualify.\textsuperscript{84} It is reasonable to regard these statements as applicable to the one class requirement of subchapter S, both because of the similarity of the provisions, and because allocation problems would exist if two classes of stock were present.\textsuperscript{85} Thus, avoiding allocation problems is a prerequisite of any solution to debt/equity disputes.

There is an additional reason for the one class requirement, although it is of more indefinite content. Under the Senate version of the 1954 provisions, each shareholder had to be "actively engaged in the conduct of the business of the corporation—\textit{i.e.}, such shareholders must all occupy managerial positions."\textsuperscript{86} This requirement was not enacted, but to a certain extent, it may be practically accomplished through the combination of a limit of ten shareholders and one class of stock. Arguably, the limitations are intended to force any corporation, seeking to spread beneficial interest among a large number of parties, to use normal corporate taxation provisions. To the extent that debt may be used in the place of preferred stock, its use may contradict the policy of keeping the corporation equivalent to a small partnership.\textsuperscript{87}

IV. Suggested Approach to Analyzing Debt-or-Equity Issues

The final portion of this Note will suggest an approach to resolving disputes over the effect of extensive use of "debt" instruments by a subchapter S corporation. The proposal is made in two parts. The first focuses on the significance of a high debt/equity ratio in a subchapter S corporation. The second will consider briefly the use of debt for functions normally performed by preferred stock.

A. The Significance of High Debt/Equity Ratios

The first step of the proposal may be stated quite simply: if a high debt/equity ratio exists and the thin capitalization doctrine is argued, the Commissioner should be required to show that the debt instruments are providing a tax benefit which could not be obtained by the sub-

\textsuperscript{84} Id. at 119, 1954-3 U. S. CODE CONG. & AD. NEWS 4752 (1954).
\textsuperscript{85} For analysis of the legislative history in relation to differences in voting rights, see Note, Stockholder Agreements and Subchapter S Corporations, 19 TAX L. REV. 391, 395-99 (1964).
\textsuperscript{87} See Price, Subchapter S—Some Policy Questions, 3 Tax Revision Compendium, House Ways and Means Committee 1731 (1959).
stituted use of stock. If no benefit is present, the debt-or-stock issue should not be reached. The effect of the proposal may be illustrated by applying it to the Gamman facts. The deduction claimed by the taxpayers was their share of the corporation's operating losses. The disputed advances were made in the form of debt. If stock instruments are substituted entirely for the debt instruments, the taxpayers would claim precisely the same deduction. Thus, the case should be dismissed.

The justification for this approach is that if debt or stock produce identical tax consequences, the ratio, in and of itself, is of no tax significance. In the normal thin capitalization case, the Commissioner disallows a deduction flowing from the use of debt, not from a particular capital structure. Absent a loss of revenue due to a tax benefit flowing from debt, the Commissioner would have no reason to bring the taxpayer to court. The situation should be no different under subchapter S. Of course, the Commissioner is claiming a loss of revenue, but the loss is wholly unrelated to the debt; the taxpayer would be claiming the same deduction regardless of whether the instrument is stock or debt.

A possible argument against the proposal is that at some future time the debt may be used to actual advantage and therefore the potentiality of abuse should be eliminated. The examples in Part I demonstrate that a tax benefit from the use of debt is possible but will occur less frequently under subchapter S than under normal taxation. In view of the limited advantages possible, it seems unfair to subject the shareholder of a subchapter S corporation to the penalty of disqualification solely because his capital structure might provide a benefit in the future. Furthermore, regardless of the practical need for a deterrent, the tax law is concerned with actual abuses. The Supreme Court has aptly stated:

It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity ... that deprives the wrongdoer of the fruits of his wrong.

An advantage of the proposal is that the difficult issue—whether the instrument is debt or stock—will not have to be decided in every case. The first question is whether the use of debt itself provides a tax

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89 In W. C. Gamman, 46 T.C.—, No. 1, CCH TAX CT. REP., decision 27,900 (1966), Dawson, J., concurring, stressed the harshness of the Commissioner's position. See Salkin, supra note 55, at 117.
90 Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948).
benefit. If the answer is negative, there is no need for going farther. If a tax benefit later occurs, the issue may be reconsidered at that time. Until this occurs, an attack on the use of debt is essentially premature and should be dismissed.

This analysis is consistent with the policy of avoiding allocation problems. Allocation problems do not arise as long as there is only one class of stock. Until determined otherwise, a debt instrument will be presumed legitimate and allocation handled accordingly. This presumption needs no judicial stamp of approval when it is not contested in an appropriate manner.

Up to this point, the argument might be summarized by saying that, until an actual tax benefit flowing from the use of debt is shown, there is no genuine issue of debt-or-stock designation. Attention now shifts to situations where an actual benefit is present, and thus where there is a genuine debt-or-stock issue.

The simple approach to deciding the genuine stock-or-debt issue is to use as precedents the normal thin capitalization cases. Before accepting this approach, significant differences should be noted in the issue when presented in a subchapter S context as opposed to the normal corporate tax situation. Most advantages from the use of debt depend upon the existence of current or accumulated earnings and profits. Debt permits tax-free withdrawal of funds instead of taxable stock redemptions. There have been "normal" thin capitalization cases which have involved challenged "loan repayments." The thin capitalization doctrine has been developed largely, however, in cases involving challenged interest deductions. Serious doubts have been raised as to whether identical issues are involved in the two situations. The distinction may not be critical under normal corporate tax provisions because it appears that the interest deductions will be challenged before loan repayments occur. Under subchapter S, however, the interest deduction issue is moot, and thus the instances where an actual benefit is likely to occur will pose only the issue of the legitimacy of loan repayments. To the extent that the "normal" thin capitalization cases fail to distinguish the situations, their application will blur the issue under subchapter S.

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61 See note 63 supra and accompanying text.
62 See, e.g., Jennings v. United States, 272 F.2d 842 (7th Cir. 1959); Estate of Miller, 24 T.C. 923 (1955), rev'd, 239 F.2d 729 (9th Cir. 1956).
64 Id. at 42-43.
65 Id. at 40.
Another difference in the debt-or-stock issue relates to the impact of the penalties. Under subchapter S, holding the instrument to be debt may result in what might be called a "double penalty", i.e., loss of both the actual benefit which would accompany debt classification and, because of disqualification, the benefits of subchapter S status. In the normal case, the penalty is directly related to the benefit sought, and thus the size of the benefit is unimportant. Under subchapter S, however, there is no necessary relation between the "two" penalties. For example, the Commissioner may show that debt rather than stock classification gives a one hundred dollar benefit. Disqualification, on the other hand, may result in a tax cost of 1,000 dollars to the taxpayer. A court might feel that disqualification was an overly harsh penalty. The Gamman solution is attractive in such a case because it would deny the benefit of debt classification but would not disqualify the corporation. Because of the difficulties with Gamman, however, an alternative may be preferable.

The severity of the double penalty should be carefully weighed against the seriousness of the abuse. If the debt classification provides a benefit which is small in comparison with the penalty of disqualification, the court might allow the instruments to stand as debt. An immediate objection to such a process is that an instrument could be held debt under subchapter S whereas it would have been held stock in a normal situation. Further, once the instrument was found to be debt, the corporation could terminate the subchapter S election and rely on the finding for normal corporate tax purposes. However, the very existence of the thin capitalization doctrine demonstrates that the classification of an instrument represents a judgment of how tax policy is served by the classification. If this is accepted, a court should be willing to admit frankly that the same instrument may be debt for purposes of subchapter S and stock for purposes of normal corporate taxation. It follows that the subchapter S classification should not necessarily be res judicata in subsequent litigation under normal corporate tax provisions.

It appears that neither this solution nor Gamman is free from difficulties. As noted, Gamman in effect disregards the statutory limitation of one class of stock. The proposal, while it does not infringe on the statutory language, does force an all-or-nothing approach to limiting the tax benefits of debt classification and subchapter S status.

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96 See text accompanying notes 76-77 supra.
Tested against the policy of avoiding allocation difficulties, the alternative proposal seems preferable. Under *Gamman*, allocation problems arise as soon as there is a transfer of an instrument or a shareholder seeks to enforce the differing terms of the instrument as he is able to do under state law. Allocation problems, of course, cannot arise under the alternative proposal because the instrument is either debt, or subchapter S status is lost.

**B. Using Debt to Perform the Function of Preferred Stock**

The one class requirement prevents a subchapter S corporation from arranging a capital structure which provides the benefits of preferred stock. 7 One or more classes of preferred stock allow for considerable flexibility in allocating risks of loss, power of control, and participation in the proceeds of the business. 8 Subchapter S shareholders may seek the same flexibility through carefully drafted debt instruments. The rationale behind the use of debt is essentially different from the rationale behind the earlier examples involving high debt/equity ratios. Tax considerations may be of minimal importance. For example, an employer may desire to allow employee participation in the business. 9 When tax considerations are important, the issue may appear similar to the cases dealing with hybrid securities, where the terms of the instruments were essentially those of preferred stock, gearing "interest" payments to income and expressly providing for subordination to general creditors. 10 However, under subchapter S, the attack on such securities should be viewed as based on a separate ground. In the hybrid cases, the tax considerations which prompted the hybrid securities were attempts to derive the normal tax benefits of debt from what, from a business point of view, was in substance preferred stock. 11 Under subchapter S the attempt may be simply to acquire the non-tax benefits of preferred stock. Of course, hybrids may be utilized in one of the situations considered earlier. In such cases, they would present the same tax avoidance problem as would orthodox debt instruments. Their specific use as preferred stock possibly may be attacked on the

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8 For a general discussion of the characteristics of securities, in both their business and tax aspects, see Baker & Cary, *Corporations, Cases and Materials* 867-87 (3d ed. abr. 1959).

9 See Caplin, *supra* note 97, at 194.

10 See, e.g., John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); Gregg Co. of Del. v. Commissioner, 239 F.2d 498 (2d Cir. 1956), affirming 23 T.C. 170 (1954). Customarily, the cases involve challenged interest deductions. See cases discussed in Goldstein, *supra* note 93, at 10-17.
ground that they allow a subchapter S corporation to function as a normal, widely-held corporation, contrary to the statutory purpose as evidenced in the one class and ten-or-less shareholder requirements. This argument may be made without regard to whether there is an actual or potential tax-avoidance problem. Furthermore, it has little relation to the debt/equity ratio factor of the thin capitalization doctrine. Thus, if it is determined that there is a policy against the flexible arrangements possible in a capital structure employing preferred stock, new criteria will be necessary. The uncertainty of the concept of "small business" under subchapter S makes it impossible to set out precise rules. Perhaps as a general rule, the two items which should be looked at most closely would be the voting rights and interest rights given by the disputed debt instruments. As a practical matter, since most large businesses will necessarily operate as normal corporations, uses of debt in all but extreme cases will not seriously affect administration of subchapter S provisions.

\[\text{footnote} 102\text{ There is no limit on the size of a corporation's income, assets, net worth or other financial characteristics. Bitteker, op. cit. supra note 72, at 403.}\n