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SUBCHAPTER S: DEBT RECLASSIFICATION
AND THE
ONE CLASS OF STOCK REQUIREMENT

by Paul D. Smith

Subchapter C of the Internal Revenue Code1 provides a number of benefits to the corporation which is financed primarily through shareholder owned debt, rather than equity. In order to take advantage of these provisions, incorporators, particularly those of small, closely held corporations, often finance the corporation by providing the necessary risk capital through debt. As a result of this practice, the courts have developed the "debt reclassification doctrine," under which a shareholder loan which does not in fact constitute bona fide debt can be reclassified for tax purposes as equity.2

When Congress enacted subchapter S,3 allowing qualifying corporations to elect an alternate mode of taxation, it seemed to many that it removed the incentive for such tax avoidance schemes.4 The act was heralded as "the cure-all of 'thin incorporation' difficulties."5 However, the continued strict application of the doctrine of debt reclassification has changed what Congress intended as a simple provision benefiting the small corporation, into "another maze added to the already complicated jungle of provisions" that make up the Internal Revenue Code.6 Assuming that purported corporate debt is to be reclassified as equity, must it necessarily follow that such equity constitutes a second class of stock,7 thus making the corporation ineligible for election under subchapter S?

1 INT. REV. CODE of 1954, §§ 301-95.
2 Although the name "thin capitalization doctrine" or "thin incorporation doctrine" is more commonly used, the designation "debt reclassification" is preferred since the ratio of debt to equity is only one of the considerations in determining whether purported loans are actually at the risk of the business, and, as such, to be considered equity. See Gilbert v. Commissioner, 248 F.2d 399, 406 (2d Cir. 1957). For a more extensive discussion of the cases establishing the doctrine of debt reclassification, see M. Lore, Thin Capitalization 33 (1958); Caplin, The Caloric Count of a Thin Incorporation, 43 MARQ. L. REV. 31 (1959). See also INT. REV. CODE of 1954, § 385.
3 For an excellent discussion of the history and development of the concepts underlying subchapter S, see Bravenec, The One Class of Stock Requirement of Subchapter S—A Round Peg in a Pentagonal Hole, 6 HOUSTON L. REV. 215, 238 (1968).
4 According to one of its proponents, Senator Sparkman of Alabama, the purposes of subchapter S were to grant tax relief to small businesses and, as a companion to subchapter R which permitted some partnerships to elect to be taxed as corporations, to eliminate the influence of the federal income tax on the selection of the form under which a business association would be organized. 104 CONG. REC. 5014-15 (1958). Subchapter R was subsequently repealed (effective January 1, 1969) by the Act of Apr. 14, 1966, Pub. L. No. 89-389, § 4, 80 Stat. 111. For a discussion of the kinds of businesses which would generally find election under subchapter S advantageous, see Hrusoff, Election, Operation and Termination of a Subchapter S Corporation, 11 VILL. L. REV. 1, 2-7 (1965).
6 I. Schreiber, Subchapter S: Its Opportunities and Pitfalls 126 (1965). In spite of the problems, however, extensive use has been made of the subchapter S election. After the first 5 years of its existence, subchapter S had been utilized by 1 out of every 10 corporations. IRS, STATISTICS OF INCOME—1963, CORPORATE INCOME TAX RETURNS 141 (1968).
7 See text accompanying note 10 infra.
I. USE OF DEBT FINANCING IN THE SUBCHAPTER S CORPORATE CAPITAL STRUCTURE

A. The Subchapter S Corporation

Under the provisions of subchapter S, a "small business corporation" may elect to be exempt from income taxation at the corporate level. Instead, income and losses are passed through to the shareholders, who report their pro rata shares on their individual income tax returns.

To qualify for the subchapter S election, the corporation must meet five criteria: it must be a domestic corporation which is not a member of an affiliated group, not having more than ten shareholders, all of whom must be individuals or estates and none of whom may be non-resident aliens, and not having more than one class of stock. Moreover, the election may be filed only with the unanimous consent of the shareholders, and continues in effect until terminated. Termination may be by any of a number of means, either voluntarily by the shareholders, or involuntarily, if the corporation at any time ceases to fulfill any of the criteria for eligibility. A common cause of such involuntary termination is failure to meet the one class of stock requirement.

Taxation of the Subchapter S Corporation. An understanding of the unique principles of taxation under subchapter S is an essential prerequisite for a detailed analysis of the one class of stock requirement. Basically, the operating gains and losses of an electing corporation are passed through the corporation to the shareholders on a pro rata basis according to their stock holdings, much as in a partnership. The shareholder must include in his gross income

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8 Int. Rev. Code of 1954, § 1371(a). Although the Code uses the language "small business corporation," there is no size restriction imposed by any of the provisions of subchapter S.
9 Id. § 1373.
10 Id. § 1371(a).
11 Id. § 1372(a).
12 Id. § 1372(d).
13 Id. § 1372(e)(2).
14 Id. When a new shareholder enters the corporation, he must consent to the election within 30 days, or it is automatically terminated. Id. § 1372(e)(1); Treas. Reg. § 1.1372-3(b) (1969).
15 Int. Rev. Code of 1954, § 1372(e)(3). Of particular importance is the provision that if the corporation ceases to be eligible for election, the termination is automatically retroactive to the first day of the taxable year in which the ineligibility arose. This can bring about rather harsh consequences in a situation where no tax has been paid at the corporate level for a number of years in reliance on the election, only to have the Commissioner subsequently challenge its eligibility retroactively, assessing a substantial deficiency. Such a financial blow would be especially severe to a small business, the very type to which subchapter S was meant to be applicable.
16 Id. § 1373(d). Operating gains and losses and taxable income are computed for the subchapter S corporation in the same manner as in the conventional corporation, except for the losses allowed under § 172 and the deductions provided for in §§ 241-47. These are not available to a subchapter S corporation.
17 Id. §§ 1373(b), 1374(c). The taxable income is ordinary income in the hands of the shareholder, regardless of its character in the hands of the corporation, with one exception. The excess of the corporation's net long-term capital gain over its net short-term capital loss is treated as capital gain in the hands of the shareholder, subject to certain restrictions. Id. § 1375. See notes 36-41 infra, and accompanying text.
18 There are, however, significant distinctions between the taxation of a subchapter S corporation and partnerships. These are beyond the scope of this Comment. See B. BITTKER
not only the dividends actually distributed during the taxable year, but also his pro rata share of the corporation's undistributed taxable income (UTI) which would have been dividend income to him had the corporation distributed all of its earnings and profits on the last day of the taxable year. UTI already taxed to the shareholder, but not yet distributed, is then placed in a capital account as previously taxed income (PTI), and the basis of the shareholder's stock is increased by a corresponding amount. Since the funds held in the PTI account have already been taxed to the shareholder, they can be withdrawn without payment of further taxes. Just as his basis in his stock was increased at the time the account was credited, any subsequent PTI distribution will reduce the shareholder's basis. To the extent that the distribution exceeds the basis, it is treated as gain from the sale or exchange of a capital asset.

Leaving substantial amounts in the PTI account exposes them to significant dangers. PTI is reduced by the amount of the corporation's net operating loss which is allowable as a deduction to the shareholder. Therefore, any PTI balances not distributed prior to the incurring of corporate losses will not be available for future tax free withdrawal. Tax free distribution is also lost if the subchapter S election is terminated for any reason, even if the corporation subsequently re-elects. PTI is personal to the shareholder who has reported it on his return. Thus, a transferee of stock acquires no right to the PTI of his transferor. In the event of the death of the shareholder, any PTI to which he would have been entitled is not available to his estate, heirs, or beneficiaries. These dangers of losing PTI left in the corporation clearly constitute an incentive to keep the PTI account at the lowest possible level. However, other provisions, such as the requirement that PTI be taken out only in the form of money, often make this difficult to accomplish.

The practical operation of subchapter S can best be illustrated by example. Assume that X corporation, a corporation electing under subchapter S, has current earnings and profits and taxable income of $100,000 in 1970. During the year, it distributes $50,000 to A, its sole shareholder. The remaining $50,000 is UTI for 1970, and is taxed to A as a dividend, since earnings and

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9 INT. REV. CODE of 1954, § 1373(b).
10 Id. § 1376(a).
14 Id. § 1375-4(e). However, if the shareholder retains any stock whatever, he is entitled to the full amount of the PTI. Further, if a shareholder transfers all his stock, and subsequently reacquires any part of it while the same election is still in effect, he is entitled to all of his previous PTI balance.
15 Id. § 1.1375-4(e). See also Caplin, supra note 5, at 191. Moreover, additional problems arise when the ownership of the stock is divided between a life tenant and a remainderman, and when the stock is held as separate property in a community property state.
16 See Bravenec, supra note 3, at 221 n.49.
17 See note 44 infra, and accompanying text.
profits are adequate to cover it. This $50,000 is then credited to A's PTI account, and the basis of his stock is increased.

If current earnings and profits exceed taxable income, the result will be different. If X corporation has current earnings and profits of $100,000, but taxable income of only $40,000, the $50,000 cash distribution is still a dividend, since earnings and profits are sufficient to cover it. Since there is no undistributed taxable income remaining in the corporation, there will be no UTI tax to A. The difference of $50,000, although not taxed in the year realized, becomes part of accumulated earnings and profits. It will thus ultimately be taxed as a dividend when distributed to A.

One of the principal benefits of subchapter S is the treatment it allows for losses and gains, and the unique tax consequences which result. Ordinary losses incurred by an electing corporation are allocated among the shareholders by determining the corporation's daily loss and allocating that loss on a pro rata basis to the stock outstanding on each day. Thus, the allocation of losses is essentially the same as in partnerships, although the allocation of income basically follows the corporate rules.

One of the primary advantages of a subchapter S corporation is that, unlike a partnership or sole proprietorship, its shareholders are afforded protection from personal liability, and, at the same time, can deduct from their individual income the ordinary losses incurred by the business. The amount of the pro rata share of the net operating loss of a subchapter S corporation which a shareholder can deduct from his income is limited to the adjusted basis of his net investment, stock and debt, in the corporation. As the shareholder deducts these losses, his basis in the stock and debt is reduced by a corresponding amount. When the shareholder's share of the losses exceeds his basis in his investment in the corporation, any excess losses are, for deduction purposes, unavailable for future use. They can neither be carried forward by the shareholder nor deducted by the corporation itself. Herein lies a major distinction from the taxation of a partnership. Once the losses deducted by a shareholder

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57 This situation could occur, for example, where percentage depletion is used to determine taxable income, but cost depletion is used to determine earnings and profits, or where the corporation earns tax free income, as from municipal bonds. See Treas. Reg. § 1.312-6(c) (1) (1955).
58 See id., § 1.1373-1(g) (Example 2) (1968).
59 Only after all current earnings and profits have been distributed do distributions come from the PTI account. INT. REV. CODE of 1954, § 1375(d); Treas. Reg. § 1.1375-4(b) (1968).
60 The daily loss is computed by dividing the total loss at the end of the taxable year by the number of days in the year. INT. REV. CODE of 1954, § 1374(c) (1).
61 Id. The Code makes specific provision for the situation where a shareholder holds for only a part of the taxable year, not including the last day. The corporation's daily loss is allocated to the shareholder on a pro rata basis, but in no event to exceed his basis in the corporation.
63 INT. REV. CODE of 1954, § 1376(b). There accrues from this procedure an obvious tax advantage. The loss, when taken on the shareholder's individual return, is treated as an ordinary loss. Since it correspondingly reduces the shareholder's basis in his stock, it is recaptured as a capital gain upon disposition of the stock. In other words, the shareholder is allowed to exchange an ordinary loss for a capital gain.
64 INT. REV. CODE of 1954, § 704(d). This section provides, in part, that any unused loss can be carried forward by a partner until such time as his basis is increased sufficiently to offset the loss.
of a subchapter S corporation exceed his basis in the corporation, however, the basis can be increased again only by additional investment in the business, either in the form of equity or debt, or subsequent accumulations of PTI.

In an ordinary corporation, dividends paid out of current earnings and profits are taxed to the shareholders as ordinary income. The corporation's income does not retain the characteristics of the transactions which created it when distributed as dividends. In the case of a corporation electing under subchapter S, one exception is made. The partnership conduit principle is applied to long-term capital gains. The shareholder may treat as long-term capital gain that portion of any amount includable in his gross income as a corporate dividend, to the extent that it is paid out of current earnings and profits, which represents his pro rata share of the corporation's excess of net long-term capital gain over net short-term capital loss during the taxable year.86

Net long-term capital gain of the corporation is reduced by ordinary deductions as well as by current and carried over capital losses in computing taxable income.87 The amount of the net long-term capital gain over the net short-term capital loss can, therefore, be in excess of taxable income. The electing corporation could take advantage of this to pass through a portion of accumulated earnings and profits at capital gains rates where the excess of net long-term capital gains over net short-term capital loss is, in fact, greater than current earnings and profits. To prevent this, Congress restricted the amount allocable as capital gains to the amount of the taxable income of the corporation for the taxable year.88

The Code also provides for a further restriction on the amount of capital gains which can be passed through to the shareholder without being taxed at the corporate level.89 Under this provision, most corporations90 are taxed if the excess of the net long-term capital gain over net short-term capital loss exceeds $25,000 and fifty percent of the corporation's taxable income for the year.91 The amount of the tax is the lesser of the section 1201 tax on the excess over the $25,000 ceiling or the section 11 tax on the entire taxable income of the corporation.

Unlike partnerships, the capital losses of a subchapter S corporation are not passed through directly to the shareholders. The only benefit the shareholders derive is if the corporation has capital gains, because the capital gains are reduced by capital losses and the net capital gain does pass through to the shareholders.92 As with conventional corporations, the subchapter S corpora-

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86 Id. § 1375 (a).
87 In this computation, the electing corporation must net the gains and losses from the sale of real or depreciable property used in the trade or business and cannot pass through the ordinary deduction and capital gains separately. Such net long-term capital gain of the corporation, however, will not be set off against a net loss from the sale of real or depreciable property realized by the shareholder.
88 INT. REV. CODE of 1954, § 1375 (a) (1).
89 Id. § 1378.
90 The Code specifically excepts certain corporations from the tax imposed by § 1378. Excepted are electing corporations whose election has been in effect for at least 3 years and those which are not more than 4 years old and have had an election in effect for each of the years of its existence.
91 INT. REV. CODE of 1954, § 1378 (a).
92 Id. § 1375 (a) (1).
tion is entitled to carry forward an unused capital loss for five years.\textsuperscript{43} Thus, the only way the corporation's shareholders will derive any benefit from some or all of the capital losses is if the corporation has capital gains within the six-year span of the current and the next five succeeding years. If no capital gains occur, the capital losses will never be useable.

Distributions of property by a subchapter S corporation can be from previously taxed income, and as such tax free to the shareholders, but only if the distribution is in money. Distributions of property other than money are not treated as coming from PTI.\textsuperscript{44} The purpose of this rule is to prevent the distribution of appreciated property tax-free to the shareholder whose basis would then be equal to the fair market value of the property. Thus, were it not for the rule, no tax would ever be paid on the appreciated value. For example, assume that A, shareholder in X corporation, an electing subchapter S corporation, has a PTI balance of $10,000. X owns property in which it has a basis of $10,000, but which has appreciated to a fair market value of $15,000. If X could distribute the property to A as a tax free distribution of PTI, A's basis in the property, according to conventional corporate concepts, would be the fair market value at the time of the distribution, or $15,000. The $5,000 of appreciated value would completely avoid taxation. Thus, any distribution of property other than money is treated as a dividend.\textsuperscript{45}

In practice, this rule could cause a situation where a subchapter S corporation could not make a distribution of PTI. If the corporation has insufficient cash to make a distribution in money, it can make the distribution only by selling an asset. But, if that sale generated income, as would presumably be the case in the type of situation to which the rule is directed, then the distribution of the proceeds would be at least in part from current earnings and profits, and not from the PTI account. The dangers of leaving a balance in PTI\textsuperscript{46} are, thus, in some cases, difficult to avoid, and must be planned for carefully.

The One Class of Stock Requirement. The requirement that an electing corporation have only one class of stock outstanding\textsuperscript{47} has been one of the major sources of confusion, controversy, and litigation to arise under the provisions of subchapter S. The greatest problem has centered around the question of how stiffly the requirement is to be applied in disqualifying a corporation

\textsuperscript{43} Id. § 1212(a) (1) (B). The 3-year carryback, however, is not allowed to a subchapter S corporation. Id. § 1212(a) (3).

\textsuperscript{44} Treas. Reg. § 1.1375-4 (b) (1968). See also INT. REV. CODE of 1954, § 1375(f); C.D. Fountain, 59 T.C. No. 69 (Feb. 22, 1973); Randall N. Clark, 58 T.C. 2533 (1972).

\textsuperscript{45} Although the validity of the applicable regulation, id., has been attacked, DeTreville v. United States, 445 F.2d 1306 (4th Cir. 1971), it is unlikely that it will or should be changed absent legislation that will deal with the problem of the avoidance of tax on appreciation. One solution to the problem would be to adopt the partnership form for purposes of an electing corporation. If all earnings and profits of the subchapter S corporation were treated as they are in partnerships, the basis of the corporate stock being increased by earnings and decreased by distributions, distributions of property could be made against basis, and the corporation's basis for the property could carry over to the shareholder who would individually realize the gain on any appreciation when he sold the property. See INT. REV. CODE of 1954, § 732.

\textsuperscript{46} See text accompanying notes 24-25 supra.

\textsuperscript{47} INT. REV. CODE of 1954, § 1371(a) (4).
which otherwise would be eligible for the election. Although the purpose of Congress in imposing the restriction is not clear, there is no reason to believe that it was designed to restrict the size of a qualifying corporation. In fact, it is not at all unusual for a small, closely-held corporation to have a second class of stock to provide for such problems as differing family interests and corporate control.\textsuperscript{48} Nor is there any indication that Congress had in mind the prevention of tax avoidance through the manipulation of two classes of stock.\textsuperscript{49}

The question is further obscured by the absence of congressional committee reports in 1958, the year subchapter S was enacted, discussing the one class of stock requirement. A provision very similar to subchapter S was considered in 1954, which contained the requirement that a corporation have only one class of stock. The pertinent Senate committee reports of that year indicate that the purpose of the requirement was twofold: to accomplish administrative ease by preventing the complexities which would result from having to allocate earnings among several classes of stock, and to avoid the administrative problems created by payment of dividends on preferred stock in excess of the current year's earnings.\textsuperscript{50}

If administrative ease is the basis for the one class of stock requirement, rather than equity or economic policy, there is no justification for expanding the requirement beyond the area of allocation of income. Therefore, for purposes of eligibility for election under subchapter S, differing rights not affecting the allocation of the corporation's earnings should not be deemed as giving rise to a second class of stock.\textsuperscript{51} In the case of a class of preferred stock, there would be no administrative problem in allocating the subchapter S corporation's earnings in the event that such earnings were sufficient to cover the preferred dividends for the year. Whether or not the dividends were paid, the preferred stockholder could be taxed on the amount of the dividend he would have received, and the excess earnings taxed to the common shareholders. Those preferred dividends taxed, but not yet distributed, would then be available for future tax-free distribution to the preferred shareholders.

The Senate committee report expressed concern over the problem of a dividend paid to preferred shareholders in excess of current earnings and profits, since the excess would have to come out of the common shareholders' PTI accounts.\textsuperscript{52} For example, if X, an electing subchapter S corporation, had earnings of $50,000 in 1970 and paid a required dividend of $25,000 to its preferred shareholders, the balance of $25,000 is taxable to the common shareholders as UTI. Assuming that no distribution is made to the common

\textsuperscript{48} See text accompanying notes 97-98 infra.

\textsuperscript{49} One such avoidance problem could arise from a family situation in which the father owned all the common stock and actively conducted the business, while the children owned the preferred stock and shared in the earnings, thus transferring the income into lower brackets. The Code adequately provides for this by authorizing the Commissioner to reallocate the income among the family members so as to reflect the value of services actually rendered to the corporation. INT. REV. CODE of 1954, § 1375(c).

\textsuperscript{50} S. REP. No. 1622, 83d Cong., 2d Sess. 119, 453-54 (1954). See also Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972). This conclusion is given further support by the Committee Reports of 1964, when certain provisions of subchapter S were amended. See S. REP. No. 830, 88th Cong., 2d Sess. 146 (1964).

\textsuperscript{51} Unfortunately, the Service has not taken this position. See, e.g., Rev. Rul. 63-226, 1963-2 CUM. BULL. 341.

\textsuperscript{52} See text accompanying note 20 supra.
shareholders in 1970, their PTI accounts are credited by an aggregate of
$25,000. If in 1971 (or any year thereafter) the corporation has no earnings
and profits, the $25,000 retained in 1970 would be distributed as dividends
to the preferred shareholders, but there would be no tax due, the tax already
having been paid by the common shareholders in 1970. The result is that the
common shareholders have paid the income tax on $25,000 which was in
reality income to the preferred shareholders.

Although this situation seems to offer a convincing argument in favor of
the one class of stock requirement, the common shareholders would not
necessarily be without protection under the existing Code provisions. The
shareholders could cause all income to be distributed to the shareholders in
the year earned.\(^{23}\) In addition, Congress could provide a remedy by allowing
the common shareholders a loss of $25,000 in 1971. In the event that the
preferred stock was noncumulative, there would, of course, be no problem. If
a dividend were not paid for a year, there would be no transfer of PTI from
the common to the preferred shareholders. Thus, it appears that for most pur-
poses subchapter \(S\) rules could be revised to allow for more than one class of
stock without unduly complicating their administration for tax purposes.

B. Corporate Debt Financing: The Debt Reclassification Doctrine

There exist a number of motivations in the tax laws for corporations to use
debt rather than equity financing in the corporate capital structure. The chief
advantage to the corporation lies in the fact that interest payments made to a
creditor-shareholder for loans made by him to the corporation are deductible,
whereas dividends paid on his stock are not.\(^{24}\) Moreover, issuance of debt
securities rather than stock can protect against imposition of the accumulated
earnings tax.\(^{25}\) The accumulation of earnings within the corporation to provide
for repayment of outstanding debt is considered a reasonable business pur-
pose,\(^{26}\) and as such is not subject to the tax.\(^{27}\) Finally, the exchange of cor-
porate debt securities for depreciable property transferred by shareholders to
a controlled corporation may also result in tax benefits. Since it is likely that
short-term debt instruments would not be classified as securities within the
meaning of section \(351,\)\(^{28}\) the corporation may be able to avoid the nonrecog-
nition provisions of that section, and, in so doing, acquire an increase in its
basis of the property by transferring such obligations in exchange for the
property.

\(^{23}\) Such an alternative is even more advisable in view of the tax disadvantages in leaving
PTI in the corporation. See notes 22-25 \textit{supra}, and accompanying text. Total distribution of
earnings and profits could, however, seriously impede the corporation's growth.

\(^{24}\) \textsc{Int. Rev. Code} of 1954, § 163(a). Payments made as interest are considered to be
ordinary and necessary business expenses, while dividends are normally distributions of
profits.

\(^{25}\) \textit{See id.}, § 531.

\(^{26}\) \text{Gazette Tel. Co., 19 T.C. 692 (1953), aff'd, 209 F.2d 926 (10th Cir. 1954).}\ Where,
however, the debt is not bona fide, but utilized as part of a scheme to avoid the accumulated
earnings tax, such accumulations will no longer be treated as part of the reasonable needs
of the business.

\(^{27}\) \textit{Id.} at 703; \textit{see Int. Rev. Code} of 1954, § 533.

\(^{28}\) \textit{Id.}, § 351. This section provides for nonrecognition of gain or loss on the transfer
of property to a corporation by one in control of the corporation. It is thus potentially ap-
licable to most corporations of the type most likely to elect under subchapter \(S,\)
There are also certain advantages to the shareholder in contributing the necessary risk capital to the corporation in the form of loans, rather than equity. Through the use of debt financing, the shareholder can accomplish a tax free withdrawal of funds from the corporation. Repayment of a debt generally is considered as a return of capital, and thus a nontaxable event, whereas a stock redemption is taxable to the shareholder, either as capital gain or ordinary income. Further tax benefits to the shareholder arise if the corporation fails, for he may be able to take an ordinary bad debt deduction for debt capital, whereas this would generally not be the case for equity capital. Finally, the use of debt financing can also provide benefits in a possible future merger or refinancing of the corporation.

The potential tax savings made possible through these benefits have given rise to a number of "thin corporations"—those corporations whose financial structure is composed predominantly of debt, rather than equity. In order to avoid certain taxes, the shareholders fund the corporation with a minimum of equity capital, and a much greater amount of debt capital. The courts responded to this method of tax avoidance by developing the debt reclassification doctrine, under which the debt capital is, for tax purposes, reclassified as equity capital. A number of factors are generally considered in determining whether or not to reclassify. The prime factor in early cases was the overall debt/equity ratio of the corporation involved. Later decisions began to consider additional factors, such as whether the debt instruments were held pro

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59 Even if the amount received is more than the debarholder's basis in the debt, the excess is taxed only as a capital gain under the provisions of § 1232(a)(2). If the debt is retired at less than its face amount, however, the corporation will realize ordinary income. Commissioner v. Jacobson, 336 U.S. 28 (1949); INT. REV. CODE of 1954, § 61(a)(12). However, recognition of that gain can be postponed by an election by the corporation to reduce its basis in one of its assets under §§ 108(a) and 1017.

60 See INT. REV. CODE of 1954, §§ 301(c), 302(c)(2), 302(d).

61 Id. § 166. Most shareholders will be limited to the short-term capital loss allowed for nonbusiness bad debts.

62 If, in such a reorganization, the principal amount of debt securities received does not exceed the principal amount of debt securities surrendered, taxable gain will not arise. See id. § 354(a); Caplin, supra note 2, at 32; Silverman, Debt in Corporate Amalgamations, 44 Va. L. Rev. 873, 885 (1958).

63 The most common schemes are those designed to prevent the so-called "double tax" imposed on corporate income. See Dunn, Thin Incorporation: The Debt-Equity Issue, N.Y.U. 28TH INST. ON FED. TAX. 309 (1970). The corporation's income is taxed once as income to the corporation, and, if distributed as dividends to the shareholders, it is taxed a second time as income to them.

64 Among the cases dealing with the deductibility to the corporation of interest paid by it are Wood Preserving Corp. v. United States, 347 F.2d 117 (4th Cir. 1965); Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963); Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956). The effect of the distribution of funds from the corporation in repayment of principal was dealt with in Moughon v. Commissioner, 329 F.2d 399 (6th Cir. 1964); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786 (3d Cir. 1962). The treatment of the loss on the debt was considered in Arlington Park Jockey Club, Inc. v. Sauber, 262 F.2d 902 (7th Cir. 1959); Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959).

65 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 (1955), and cases cited therein. There have been attempts to determine what corporate debt/equity ratio would be safe from the threat of reclassification. Based on certain early cases, such as John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), and Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944), aff'd sub nom. John Kelley Co. v. Commissioner, 326 U.S. 321 (1946), it appears to some that 4:1 marks the boundary. See Caplin, supra note 2; N.Y.U. 17TH INST. ON FED. TAX. 771, 783-84 (1959).
rata by the shareholders, whether the funds represented by the debt were used to purchase assets essential to the formation of the business, and such subjective factors as whether the holder of the debt intended to treat the debt as would an outside creditor.

The general trend seems to be that when the capital structure of the corporation is such that an outside creditor would not advance funds to it, the fact that a shareholder did make such an advance raises the presumption that his sole motive was tax avoidance. When necessary to prevent this attempted avoidance of the corporate tax imposed by subchapter C, the courts will reclassify the debt capital as equity, thus depriving the corporation of the advantages sought in the impermissible debt financing.

C. The Uses of Debt Financing in the Subchapter S Corporation

The unique principles of corporate taxation under subchapter S, allowing

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66 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 court emphasized the fact that the debt and equity were not held pro rata, stating in dicta that only in the case of pro rata holding is there a maximum incentive to issue debt. However, even if the holding is not pro rata, a court may reclassify the debt as equity. Reed v. Commissioner, 242 F.2d 334 (2d Cir. 1957).


68 Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956).

69 The normal debt/equity ratios for close corporations cannot be determined because of the inherent nature of such a closely held corporation and the fact that there is little financial data available as to their capital structures. Generally, normal credit standards will call for different capital structures within different industries. The more speculative the industry or business, the less likely is a bona fide creditor, with an expectation of repayment regardless of the success of the business, to advance funds to a corporation with a high debt/equity ratio. The court is thus less likely to sustain the capital advance as a bona fide indebtedness. For example, where the stockholders paid in $15,000 to a corporation organized to drill for oil, of which $14,000 was allocated to debt, the court refused to recognize the debt as such, but considered it to be equity. Michael Cohen, 3 CCH Tax Ct. Mem. 236 (1944), aff'd, 148 F.2d 336 (2d Cir. 1945). If such a highly speculative venture proved unsuccessful, the creditors' interests would probably be wiped out as quickly as those of the stockholders. Hence, the risk involved in a particular business venture should be a factor leading to a reclassification of debt as stock. See Brinker v. United States, 116 F. Supp. 294 (N.D. Cal. 1953). As a general rule, the more stable the industry as a whole, and the particular business involved, the higher will be the financial ratio acceptable to the courts. G. PATON, ACCOUNTANT'S HANDBOOK 78 (1967). Most of the decisions, however, where the thin capitalization test has been applied to reclassify purported debt have involved ratios which would be abnormally high in any industry. See, e.g., Robert L. Osborne, 13 CCH Tax Ct. Mem. 428 (1954); Hilbert L. Bair, 16 T.C. 90 (1951), aff'd, 199 F.2d 589 (2d Cir. 1952); Swoby Corp., 9 T.C. 887 (1947). The conclusion seems to be that if a disinterested lender would not have made the advances, there will likely be at least a potential reclassification problem. See Brinker v. United States, 116 F. Supp. 294 (N.D. Cal. 1953); Samuel T. Tauber, 11 CCH Tax Ct. Mem. 269 (1952); Erard A. Matthiessen, 16 T.C. 781 (1951).

70 Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); R.E. Nelson, 19 T.C. 575 (1952); Isidor Dobkin, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951); cf. Erard A. Matthiessen, 16 T.C. 781 (1951), aff'd per curiam, 194 F.2d 659 (2d Cir. 1952).

71 The mere presence of a tax motive is not, in itself, sufficient basis for reclassification. Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Newman, 159 F.2d 848 (2d Cir. 1947). However, the courts have held that if there is no other purpose for the transaction, such is evidentiary of the fact that the alleged debtor-creditor relationship is a sham. Kraft Foods Co., 21 T.C. 513 (1954); H.E. Fletcher Co., 10 CCH Tax Ct. Mem. 1025 (1951); cf. The Humko Co., 2 CCH Tax Ct. Mem. 1121 (1943); Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952). But see Sun Properties v. United States, 220 F.2d 171 (3d Cir. 1955).
the pass-through of earnings and losses to the shareholders, remove many of the advantages of internal debt financing. The exemption from the double tax imposed on corporate income by subchapter C has prompted some to the view that there is, in a subchapter S corporation, no advantage, tax or non-tax, in substituting debt capital for equity capital. To a certain extent, this is true. For example, assume that \( A \) owns sixty percent of a subchapter S corporation and \( B \) owns forty percent, each having loaned the sums of $6,000 and $4,000, respectively. If they are to be paid $300 and $200 on the advances yearly, it will make no difference whether such payments are denominated interest or dividends. Assume that in 1970 the corporation earns $1,000 before making the payments to \( A \) and \( B \). If the payments are considered interest, the corporation will have $500 income after making them, and \( A \) and \( B \) will have interest income of $300 and $200, respectively. Moreover, \( A \) will be taxed on an additional $300 and \( B \) on an additional $200 of UTI, whether actually paid to them or not. If the corporation has no earnings in 1971, or in any year thereafter, but makes the payments to \( A \) and \( B \), they would again be subject to tax on the interest income, but there would also be a net loss to the corporation of $500, which would be passed through to the shareholders proportionally. The same net results would ensue if the payments were made in the form of dividends, rather than interest. In 1970 the shareholders would be taxed on $500 of dividend income and $500 of UTI; in 1971 the payments would be made out of their respective PTI accounts, and as such would not be taxable.

In spite of the foregoing, there still remain a number of reasons, non-tax as well as tax, why a subchapter S corporation might desire to use debt financing to a certain degree.

Use of Debt for Income Splitting. If the subchapter S corporation is wholly owned by members of one family, debt financing has been used to distribute most of the corporate income to those family members who are in lower income tax brackets, who receive shares. The bulk of the capitalization would be obtained by having the members of the family in high income tax brackets contribute in the form of loans, in return for notes bearing little or no interest. UTI would thus be taxable only to the shareholders. Such a plan

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The use of debt capital to achieve intrafamily income splitting has long been recognized as an illegitimate form of tax avoidance. See, e.g., Corliss v. Bowers, 281 U.S. 376 (1930); Lucas v. Earl, 281 U.S. 111 (1930). See also S. Surrey & W. Warren, Federal Income Taxation 939-40 (1960). Certain business and estate planning goals, on the other hand, are entirely proper. The permissibility of use of debt capital to protect PTI, preserve the loss deduction, remove earnings and profits, and make distributions in kind is as yet undetermined.

Another similar technique is to have the shareholder-creditor make loans, evidenced by notes paying as interest a stated percentage of the net profits of the corporation. This obvious attempt to approximate a class of preferred stock has been challenged by the Com-
would be feasible only if there is an expectation that the corporation will have earnings which the shareholders do not intend to withdraw. Otherwise, if losses are anticipated, as is often the case for fledgling corporations, the family members in the higher income tax brackets would want to receive as great a proportion of the losses as possible, and would, therefore, subscribe to the stock themselves.

Protecting the PTI. Because of the dangers inherent in leaving balances in the shareholders' PTI accounts, it is generally desirable to withdraw from these accounts as quickly as possible. There is a problem, however, when the corporation needs to retain all or part of its earnings for the stability or expansion of the business. The best solution from a protection standpoint is to distribute all earnings before the close of each year, and have the shareholders immediately loan them back to the corporation. Such an arrangement meets the economic needs of the business, protects against the dangers of loss of PTI, and still allows tax free withdrawal of income which has already been taxed.

Preserving the Shareholders' Loss Deduction. Once a shareholder has deducted as corporate net operating losses an amount equal to his total investment in the corporation, he may take no further loss deductions until such time as his basis is increased. If the shareholder desires to continue the business after his basis has been exhausted, he must make additional loans or equity contributions in order to be able to continue to deduct further operating losses.

Removal of Earnings and Profits in Excess of Taxable Income. Difficulties may confront a subchapter S corporation which has current earnings and profits in excess of its taxable income. Such could be the case when it receives tax exempt income or utilizes percentage depletion. As a result of this disparity, actual distributions could bring about dividends greater than the corporation's taxable income. By the use of debt, however, the excess may be taken out tax free. Assume that A is the sole shareholder of a subchapter S corporation. In 1970 the corporation has $100,000 of taxable income and $25,000 of tax exempt income. If no distributions are made, A will be taxed on $100,000, and his PTI account will be increased by a like amount. If $125,000 is subsequently distributed, A will be taxed on $25,000. If, however, A held a debt instrument for $25,000, the corporation could distribute $25,000 in repayment of the debt. Such a payment would be a return of capital to A and, as such, nontaxable. The same analysis would

missioner on at least one occasion. See Portage Plastics Co. v. United States, 73-1 U.S. Tax Cas. ¶ 9261 (7th Cir. 1973).

79 See text accompanying notes 22-26 supra.

80 See text accompanying notes 32-34 supra.


82 Percentage depletion reduces taxable income, while earnings and profits are reduced only by cost depletion. See Int. Rev. Code of 1954, §§ 611-17.

83 Id. § 1232.
apply if the corporation had accumulated earnings and profits from a prior year. Assume the preceding hypothetical situation was altered so that the corporation had accumulated $25,000 of earnings and profits prior to making an election under subchapter S in 1970. During 1970 the corporation has $100,000 of taxable income, but desires to distribute $125,000. Dividend treatment may be avoided by repayment of a $25,000 debt.

*Distributions in Kind.* Issuance of debt securities is also useful as a means of overcoming the disadvantages of distributions of property other than money by a subchapter S corporation. Unlike the treatment of a distribution by an ordinary corporation, a distribution in kind by a subchapter S corporation can, under certain circumstances, result in greater dividend income to the shareholder than would be the case had the distribution been in cash. Because of the rule that distributions of property do not reduce the amount of UTI taxable to the shareholders, this result can occur when the corporation has either accumulated earnings and profits or current earnings and profits in excess of taxable income. For example, assume that A is the sole shareholder of a subchapter S corporation having $5,000 of accumulated earnings and profits, and $5,000 of current earnings and taxable income. The corporation makes a distribution to A of property having a fair market value of $5,000. A three-tier system of determining the extent to which the distribution is out of current earnings must be followed:

1. Earnings and profits of the taxable year are first allocated to certain 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 (taken into account at fair market value for purposes of this allocation) which are not in exchange for stock, and
3. The remainder of such earnings and profits is available to be allocated to distributions in exchange for stock of the corporation such as distributions under section 302 or 331.

A subchapter S corporation could have accumulated earnings and profits which it had earned in prior years, or which it had already accumulated at the time of the corporation’s initial election to be taxed under the provisions of subchapter S. See notes 27 supra and 88 infra, and accompanying text.

In an ordinary corporation, the amount of a distribution to be treated as a dividend to the shareholder is not dependent upon whether the distribution is of money or in kind. If the distribution is of property other than money, it is valued at its fair market value, which amount is dividend income to the shareholder. Inr. Rev. Code of 1954, § 301.

Accumulated earnings and profits could exist in a subchapter S corporation only if it already had such accumulations at the time of its election or if they were the result of prior years in which current earnings and profits exceeded taxable income.

As with the ordinary corporation, distributions of property by a subchapter S corporation are valued at the current fair market value of the property. Treas. Reg. § 1.1372-1(c) (2) (1959).

The allocation referred to in this section of the Regulations can be stated as follows: allocate to the property that portion of the current earnings which bears the same ratio to the total current earnings as the market value of the property bears to the sum of the market value of the property and the undistributed taxable income. Allocate the remainder to UTI.
In the example, therefore, the current earnings and profits would be allocated equally to the distribution of property and to the constructive distribution of UTI—$2,500 to each. However, since there are sufficient accumulated earnings and profits to cover the value of the property, its entire $5,000 market value constitutes taxable income to A. Moreover, he must include in his gross income the amount of UTI which would have been a dividend if distributed in cash on the last day of the taxable year. Since UTI is not reduced by a distribution of property, it is still $5,000. Thus, A must report $10,000 of ordinary income, although had the distribution been in cash, he would have been required to report only $5,000 of income.

The other situation in which a distribution in kind can result in increased income to the shareholder occurs when the corporation's current earnings and profits are greater than its taxable income. Assume that the subchapter S corporation has current earnings and profits of $10,000, but taxable income of only $5,000, and makes a distribution of property worth $5,000. As before, the current earnings and profits are allocated $5,000 to the property and $5,000 to the constructive distribution of UTI. Thus, all of the UTI and the full value of the property are treated as dividends to the shareholder, a total of $10,000. Had the distribution been in cash, the UTI would have been reduced thereby, and the shareholders would have had income of only $5,000.

In spite of these disadvantages of a distribution in kind, there could easily be circumstances under which the shareholders of a subchapter S corporation would nevertheless wish to make withdrawals from the corporation in the form of property rather than cash. The procedure in such a situation would be to have the shareholders purchase the property, exchanging it for debt securities previously issued to them, whether in anticipation of such a transaction or not. The corporation may realize capital gain on such an exchange, which would in turn be passed through to the shareholders as capital gain. However, capital gain treatment would generally be preferable to the ordinary income treatment of a distribution in kind.

Business and Estate Planning. Under ordinary corporate situations, two classes

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93 See id. § 1.1373-1(d). See also INT. REV. CODE of 1954, §§ 301 (c), 316.
94 Had there been no accumulated earnings and profits, the distribution in kind would have resulted in only $5,000 of ordinary income to the shareholder. Current earnings and profits would be allocated $2,500 to the property and $2,500 to UTI, leaving a total of only $5,000 ordinary income to the shareholders. The excess of the fair market value of the property over the amount treated as a dividend would, to the extent that it exceeded the basis of the property, first reduce the basis of the shareholder's stock, and then be treated as gain from the sale or exchange of property. See INT. REV. CODE of 1954, § 301 (c) (3) (A).
95 As in the previous situation, the shareholder's ordinary income would not have varied with the form of the distribution had the taxable income not been less than current earnings and profits. If both had been $10,000, the cash distribution of $5,000 would have left $5,000 in UTI, yielding a total of $10,000 of dividend income. With a distribution in kind, the current earnings would be allocated $6,667 to UTI and $3,333 to the property, again resulting in $10,000 of dividend income to the shareholder.
96 There is some question of whether or not the provisions of § 1239 would apply were the corporation to distribute property which is subject to an allowance for depreciation. If the section were applicable, ordinary income could be generated to the corporation. See INT. REV. CODE of 1954, § 1239.
97 See text accompanying notes 37-42 supra, for a discussion of the tax treatment of capital gains under subchapter S.
of stock are often used to allow greater flexibility in planning for control and ownership of the business. This is particularly the case in close corporations, the type to which the provisions of subchapter S are generally the most attractive. For example, assume that X, Y, and Z form a subchapter S corporation, X contributing $10,000 of capital and services performed, Y contributing $20,000 of capital and services performed, and Z contributing $1,000 of capital and services performed. If each shareholder desires to elect one of the three directors, a dilemma arises. There cannot be two classes of stock, one voting and one nonvoting. To do so would clearly violate the one class of stock requirement, and thus invalidate the subchapter S election.\(^9\) If only one class of stock is used, X receiving ten shares, Y receiving twenty shares, and Z receiving one share, the goal will certainly not be reached. Nor is issuing equal numbers of shares of a single class of stock satisfactory, for to do so would not adequately provide for such problems as liquidation preferences. One logical solution would be to issue ten shares to each in exchange for an equity investment of $1,000, and have X and Y be the holders of $9,000 and $19,000, respectively, of corporate debt obligations. However, according to the position taken by the Service, this would endanger the subchapter S election under the one class of stock requirement.

In another situation, an employer may want to incorporate his business, and permit certain key employees to subscribe to the common stock thereto, while himself subscribing to a large block of a prior preference security. Similarly, in estate planning, the controlling shareholder might prefer a fixed income, nonvoting security for his wife, while giving common stock to children actively engaged in the operation of the business. Because the provisions of subchapter S preclude the possibility of using a class of preferred stock to accomplish these legitimate business and estate planning desires, only corporate indebtedness can be used. However, under the interpretation applied by the Service, debt can only be used in those relatively rare situations in which the shareholders can invest in debt obligations in substantially the same proportion to their stock holdings.\(^9\)

II. INTERPRETATION OF THE ONE CLASS OF STOCK REQUIREMENT

The threat of reclassification of debt as a second class of stock in subchapter S corporations became apparent soon after the provision became effective. The original regulations promulgated under subchapter S made clear the Commissioner's intention to apply the traditional debt reclassification doctrine to subchapter S corporations for purposes of creating a second class of stock. The original regulation stated that "[i]f the outstanding shares of stock of the corporation are not identical with respect to the rights and interests which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. . . . If an

\(^9\) See Treas. Reg. § 1.1371-1(g) (1966). The regulations provide that "a difference as to voting rights . . . of outstanding stock will disqualify a corporation."

\(^9\) See note 123 infra, and accompanying text.
instrument purporting to be debt is actually stock, it will constitute a second class of stock."

The first challenge of shareholder loans under these regulations reached the courts in 1964. In Catalina Homes, Inc. the Tax Court upheld the Commissioner's reclassification of a subchapter S corporation's debt as a second class of stock where the loans carried no maturity date, were not evidenced by any notes, were made immediately after incorporation to supplement a patently inadequate equity contribution, and payment of interest was strictly in the discretion of the obligor corporation. Having reclassified the loans as equity capital, the court considered the question of whether they constituted a second class of stock for subchapter S purposes. Although the outcome of the issue was consistent with the regulations, the court did not base its decision on the regulations alone. Rather, it looked to the facts that the interest was payable at the corporation's discretion and that no dividends could be declared on the common stock until the loans and interest had been paid in full. These preferences over the common stock were held to constitute a sufficient distinction to give rise to a second class of stock.

In Henderson v. United States a district court also upheld the Commissioner's decision that shareholder loans were actually equity capital and constituted a second class of stock. Although conceding that mere "thinness" alone was not sufficient to justify reclassification, the court emphasized the corporation's debt/equity ratio, the absence of any intent to honor the overdue obligations, and the fact that the funds from the loans were used to purchase equipment essential to the operation of the business. The court's opinion made no mention of any tax avoidance motive, nor any reference to the regulations.

Catalina and Henderson both illustrate the potentially disastrous consequences of debt reclassification for purposes of voiding an election under subchapter S. In the ordinary corporation, reclassification results only in the loss of whatever tax advantages were being sought by the use of debt rather than equity. When a subchapter S corporation is involved, however, reclassification will also result in the imposition of the usual corporate tax, and the loss of any previously taxed income retained by the corporation. In addition, the accumulated earnings tax may be imposed.

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100 Id. at 1365-66. It is noteworthy that these loans were in direct proportion to the shareholders' stockholdings.
101 In fact, the court did not even reach the question of whether or not the Regulation was valid.
102 23 CCH Tax Ct. Mem. at 1367.
104 Id. at 785.
105 The corporation had paid-in capital of $3,000 and pro rata shareholder loans of $58,000.
106 245 F. Supp. at 786.
107 See also Seven Sixty Ranch Co. v. Kennedy, 66-1 U.S. Tax Cas. 85,608 (D. Wyo. 1966), where shareholder notes were held to be genuine and as such neither equity nor a second class of stock.
108 See INT. REV. CODE of 1954, §§ 531-37. The accumulated earnings tax, imposed on unreasonable accumulations of earnings and profits in the corporation, is one from which the subchapter S corporation is exempt so long as it has a valid election in force.
As a result of these severe consequences, and the strict, arbitrary nature of the regulation's automatic second class rule, the Tax Court rejected the regulation in W. C. Gamman. The majority held that the regulation was beyond the Commissioner's authority to prescribe rules and regulations pursuant to the Internal Revenue Code. The Commissioner had disallowed

Another example of the strict interpretation by the Commissioner of the one class of stock requirement is the position taken on voting trusts or similar shareholder agreements. The Internal Revenue Service has held not only that irrevocable proxies granted by one shareholder to another gave rise to a second class of stock, but also:

In the event that the outstanding stock of a corporation is subject to any other type of voting control device or arrangement, such as a pooling or voting agreement or a charter provision granting certain shares a veto power or the like, which has the effect of modifying the voting rights of part of the stock so that particular shares possess disproportionate voting power as compared to the dividend rights or liquidation rights of those shares and as compared to the voting, dividend and liquidation rights of the other shares of stock of the corporation outstanding, the corporation will be deemed to have more than one class of stock.

Rev. Rul. 63-226, 1963-2 CUM. BULL. 341, 342. The relationship this ruling bears to the purposes behind the one class of stock requirement is difficult to see, if indeed there be any. See note supra, and accompanying text.

The authority to be given regulations promulgated by the Commissioner pursuant to the Internal Revenue Code is the central issue in much tax litigation. Such has particularly been true in cases arising out of the one class of stock requirement of subchapter S.

The doctrine was early established that substantial weight is to be given to any interpretation of a statute by the administrative officials whose duty it is to effectuate its execution. Edward's Lessee v. Darby, 7 U.S. (12 Wheat.) 126 (1827). Under the specific provisions of the Internal Revenue Code of 1934, the Commissioner is expressly delegated the authority to prescribe all necessary rules and regulations for the enforcement of the tax laws. INT. REV. CODE of 1954, § 7805. The United States Supreme Court early upheld the constitutionality of a similar congressional delegation of authority. Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916). To the extent such regulations are consistent with the statute and are not arbitrary, they will be applied with particular weight and upheld by the courts in litigation arising from such application. Commissioner v. South Tex. Lumber Co., 335 U.S. 496 (1948). In fact, they have been held to have the force of law. Maryland Cas. Co. v. United States, 251 U.S. 342 (1920). However, the power to prescribe rules and regulations is not the power to make law, but only the power to effectuate the will of Congress, as expressed by the statute. Manhattan Co. v. Commissioner, 297 U.S. 129 (1936).

A regulation may not expand or change the meaning of a revenue law, Commissioner v. Acker, 361 U.S. 87 (1959); United States v. Calamaro, 354 U.S. 351 (1957); Koshland v. Helvering, 317 U.S. 294 (1942); nor can it impose or take away any rights and privileges which the Congress has given, Russell Mfg. Co. v. United States, 175 F. Supp. 159 (Ct. Cl. 1959); nor can it impose or add conditions which Congress did not impose, unless such conditions are necessary to make effective the conditions Congress did impose, Philadelphia Elec. Co. v. United States, 117 F. Supp. 424 (Ct. Cl. 1954). Where a regulation constitutes an amendment or modification of the statute as enacted by Congress, it is beyond the power of the Commissioner, and, as such, invalid. The courts must refrain from giving effect to such a regulation. Louisville Gas & Elec. Co. v. United States, 148 Ct. Cl. 671 (1960). The test to be applied to a regulation is, thus, two-pronged. The first determination to be made is whether it is consistent with the statute: "[The Supreme] Court has many times declared that Treasury regulations must be sustained unless . . . 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." Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948). Assuming that the regulation is consistent with the revenue statute, it must also meet a reasonableness test:

The power of 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
deductions claimed by the shareholders for operating losses incurred by the corporation on the ground that debt advances made by them were in reality equity, and thus, under the existing regulations, a second class of stock. Looking to the "economic substance" of the advances, the court concluded that the purported debt capital was in reality equity capital. The significant consideration was stated to be "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business." The court also emphasized the abnormally high debt/equity ratio of the corporation's capital structure, and the fact that a disinterested outside investor would never have loaned the corporation money on the same terms as had the shareholders.

Although it held that the advances were equity, the court nonetheless refused to follow the applicable regulation, holding that the advances were not a second class of stock for purposes of the validity of the corporation's subchapter S election. The offensive element of the regulation was the absolute rule that anytime a purported debt was in reality equity it would constitute a second class of stock. The court stated that the question should rather be one of "fact in each case whether advances by stockholders in the form of loans, which in economic substance are equity capital, constitute a second class of stock..." This determination must be made in light of Congress' purpose in imposing the one class of stock requirement and the clear intent of Congress that shareholder loans be permissible, as evidenced by the provisions of section 1376, which provide special rules for adjusting the basis of shareholder indebtedness. The proper test was stated to be "whether the instruments, even though they represent equity capital, actually gave the

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Manhattan Gen. Equip. v. Commissioner, 297 U.S. 129, 134 (1936). Given these two aspects of the test, it is altogether possible that a regulation, although in complete harmony with the letter of the statute, would be adjudged unreasonable, and, thus, declared invalid. Although the dicta of the cases seems to indicate that presumptive weight is to be given the regulations, Colgate Co. v. United States, 320 U.S. 422 (1943); Fawcus Mach. Co. v. United States, 282 U.S. 375 (1931), the reality is that the courts generally make an independent consideration of the merits, and uphold the regulations if in harmony with their interpretation of the statute, Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948); Textile Mills Sec. Corp. v. Commissioner, 314 U.S. 326 (1941), but overrule the regulations if out of harmony with their own interpretation. Coady v. Commissioner, 33 T.C. 771 (1960), aff'd, 289 F.2d 490 (6th Cir. 1961); Commissioner v. Acker, 361 U.S. 87 (1959); United States v. Calamaro, 354 U.S. 351 (1957). See also Lane, Attacking the Regulations, 52 A.B.A.J. 187 (1966).

Assuming that a convincing argument could be made that the thin incorporation principle of debt reclassification, as applied to a normal corporation, should not be applied to a subchapter S corporation for purposes of giving rise to a second class of stock, thus invalidating an otherwise proper election, it would not seem to be too difficult to show that regulations to the contrary are unreasonable, even though consistent with the letter of the statute.

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113 46 T.C. at 10. See also Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957).
114 46 T.C. at 10. The debt/equity ratio of the corporation was over 2,145:1.
115 Id.
116 Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 Cum. Bull. 317. The holdings in Catalina and Henderson were held to be inapplicable to Gamman, since neither of those decisions reached the question of the validity of the regulation.
117 46 T.C. at 11.
118 Id.
holders thereof any rights and interests in the corporation different from those enjoyed by the holders of the nominal stock."

The court also expressed its feeling that debt reclassification under the thin incorporation doctrine should not be used to give rise to a second class of stock for subchapter S purposes, stating that since "[t]he underlying purposes of Subchapter S appears to be to avoid [the] double tax on corporate earnings . . . [there is] little in the way of unintended tax advantages that might be gained by having the stockholders advance funds in the form of loans rather than capital where, as here, the corporation has no accumulated earnings and profits."

The Tax Court again refused to follow the regulations in *Lewis Building & Supplies, Inc.* As in *Gamman*, the court found the corporation to be thinly capitalized where $1,000 of the capital represented equity while $18,500 was debt. The court refused to agree with the Commissioner's determination that the advances constituted a second class of stock. Rather, it found that the shareholder received no greater or different rights by reason of the advances. The significant distinction between *Gamman* and *Lewis* is that in the latter case the advances were not in the same proportion as the shareholders' stock ownership.

Shortly after the *Gamman* and *Lewis* decisions, the Commissioner revised the regulation. Applying the strictest possible interpretation of the court's opinion in *Gamman*, the new regulation 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 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 as a second class of stock."

Evidently ignoring the *Lewis* decision, the new regulation established a rule under which proportionality of the debt held by shareholders to their equity is determinative.

The first case directly dealing with the validity of the new regulation was *Brennan v. O'Donnell*. The corporation involved was capitalized with extensive use of shareholder loans, contributed in substantially, although not exactly, the same proportion as the shareholders' respective stock holdings in the corporation. The court held that the new regulation was invalid, stating that "to the extent the regulations insist that disproportionately held debt-
equity disqualify a corporation from Subchapter S treatment, they have over-reached the statute and are invalid.\textsuperscript{120} The court apparently relied heavily on the fact that the characterization of the contributions as debt did not appear to be motivated by any tax avoidance motive. Moreover, the court pointed out that to require that a corporation in need of additional funds recapitalize rather than merely allow the shareholders to make a contribution in the form of debt is hardly consonant with the purposes of simplification and administrative ease behind the imposition of the one class of stock requirement for subchapter S corporations.\textsuperscript{127}

In \textit{James L. Stinnett, Jr.}\textsuperscript{128} the Tax Court agreed with the federal district court in \textit{Brennan} and held that the new regulation was invalid. Assuming the truth of the Commissioner's contention that the debt should be regarded as equity, it did not necessarily follow that there existed two classes of stock. Although the debt was held disproportionately by the shareholders, the notes evidencing the debt did not entitle the holders thereof to any right to vote, participate in the management of the business, or share in the earnings and growth of the business. In other words, the notes carried with them none of the incidents of ownership commonly attributable to stock. Expressly refusing to apply the regulations, the court held that a debt instrument "does not give rise to more than one class of stock . . . merely because the debt creates disproportionate rights among the stockholders . . . ."\textsuperscript{129} To be considered as a second class of stock, the instrument must bear at least some of the general characteristics of stock.\textsuperscript{130}

Such was the case under the facts of \textit{Portage Plastics Co. v. United States.}\textsuperscript{121} The corporation issued certain instruments to two nonshareholders in consideration for advances of $12,500 each. The notes were payable after five years, renewable for five additional years. The interest on the advances was stated to be five percent of the corporation's net profits before taxes. Over a five-year period, $16,180 was paid in interest alone on each of the $12,500 notes. The notes contained no provision for repayment, nor was there any collateral given. These factors, together with the high debt/equity ratio, led both the district court and the circuit court of appeals to the conclusion that the notes constituted contributions to equity capital. As the opinions of both courts stated, the determinative factor was whether one making the advance

\textsuperscript{120} Id. at 1072. The court also made reference to the recently enacted provision of the Code which delegated to the Commissioner the authority "to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." INT. REV. CODE of 1954, § 385(a). Such delegation did not give any additional weight to the Commissioner's debt/equity regulations under § 1371, at least not in the eyes of the \textit{Brennan} court. In fact, Judge Pointer, writing the opinion for the court, seemed to anticipate that the delegation under § 385 was subject to attack as an unconstitutional delegation of legislative powers. 322 F. Supp. at 1073 n.7. See also Bravenec, \textit{What Are the "Hidden Effects" of Recent Legislation upon Subchapter S Eligibility?}, 38 J. TAXATION 152 (1973).

\textsuperscript{127} 322 F. Supp. at 1073.

\textsuperscript{128} 54 T.C. 221 (1970).

\textsuperscript{129} Id. at 232.

\textsuperscript{130} The court's opinion did not discuss what characteristics of stock are necessary for re-classified debt to give rise to a second class of stock.

\textsuperscript{121} CCH 1973 STAND. FED. TAX REP., U.S. Tax Cas. (73-1, at 80,511) ¶ 9261 (7th Cir. 1973), rev'd 72-2 U.S. Tax Cas. 85,325 (7th Cir. 1972).
The district court and a three-judge panel of the Seventh Circuit failed to agree, however, on the question of whether the debt capital, having been reclassified as equity, necessarily gave rise to a second class of stock. Based upon what it considered to be the purposes of subchapter S, and, in particular, the one class of stock requirement, the district court held that the "traditional debt/equity tests applied in other areas of tax litigation are [not] relevant to the general purposes of Subchapter S." The three-judge panel, however, reversed, writing the only opinion to date in which the regulation has been upheld. Having concluded that the advances were in reality equity, the court held that they must necessarily give rise to a second class of stock, the majority being "of the opinion that there is no such thing as 'non-stock equity.'"

Upon rehearing en banc, however, the court of appeals unanimously reversed the decision of the panel, and held for the taxpayer. The court declared the regulation invalid upon reasoning much like that used in the Brennan and Stinnett opinions.

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138 72-2 U.S. Tax Cas. 85,325, 85,328 (7th Cir. 1972), quoting Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942). The purported debt in this case was held not to meet the classic criteria of a bona fide debt. The court stated that the "classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." Gilbert v. Commissioner, 246 F.2d 399 (2d Cir. 1957).


140 The purposes identified by the court were (1) to permit small business to select the form of their organization without the necessity of taking into account major tax differences; (2) to avoid the administrative complexities which would arise from the allocation of earnings or losses among several classes of stock, and in particular in allocation when there is a payment of dividends on preferred stock in excess of earnings; (3) to allow small corporations, essentially comparable to partnerships and proprietorships to be taxed as such. Id. at 694.

141 Id.

142 72-2 U.S. Tax Cas. at 85,327. Accepting the validity of the regulation, the court expressly took issue with the holding in prior cases: [T]he question of whether a purported debt instrument is actually representative of an equity interest is a question quite relevant to corporations which have elected to be taxed under Subchapter S. Secondly, . . . and herein lies the crucial difference between our holding and that of others in the area, we are of the opinion that the criteria heretofore developed to determine the question of debt versus equity can and should be used in the context of Subchapter S. Id. at 85,329.

143 CCH 1973 STAND. FED. TAX REP., U.S. Tax Cas. (73-1, at 80,511) ¶ 9261 (7th Cir. 1973).

144 Id. at 80,516. Although the en banc decision brings the Seventh Circuit into line with the Fifth Circuit and the Tax Court on the one class of stock issue, the Government may reasonably be expected to file an application for writ of certiorari to the United States Supreme Court. An opinion by the Supreme Court reversing or affirming the Seventh Circuit decision could clarify the debt reclassification problem under subchapter S. However, it is altogether possible that a decision based upon the unique fact situation in Portage Plastics could set a precedent which, when applied to facts more typically arising under subchapter S, would give rise to an unintended result. The "debt" instruments involved in Portage Plastics were much more nearly characteristic of a class of preferred stock than has been the case in those instruments involved in other debt reclassification decisions. If the Supreme Court reverses, holding that reclassifying debt as equity gives rise to a second class of stock, rather than reversing, if at all, strictly on the facts involved, the issue will be resolved in a very unrepresentative fact situation. Such a decision would only serve to further complicate an already confused question.
Still another court declared the regulation invalid as being arbitrary and beyond the scope of the Commissioner's power. The court stated that there is no purpose in limiting debt obligations to those made pro rata by the shareholders, particularly if the use of the debt in question serves a purpose within the contemplation of subchapter S. Applying the debt reclassification test, the purported debt was held to be equity. The court refused, however, to consider the equity as a second class of stock for purposes of the subchapter S election. Reclassified debt is to be treated as non-stock equity.

*Shores Realty Co. v. United States,* decided the same day, reached the same result by also declaring the regulation invalid. The view taken by the *Shores* court, however, was that the debt reclassification test is altogether inapplicable to a subchapter S corporation. In view of the purposes and requirements of subchapter S, there is never any need for application of the test. The tax avoidance possibilities of thin capitalization are not present in a subchapter S corporation, and the shareholders should thus be left to capitalize their corporation as they see fit.

### III. The Purposes of Debt Reclassification in the Subchapter S Corporation

In each of the decisions arising out of the one class of stock requirement, discussed above, the purported debt was reclassified as equity. These reclassifications were arrived at through the application of the traditional doctrine of debt reclassification. The development of this doctrine evolved, however, from a long line of cases involving ordinary corporations and the tax problems unique to them. The failure of the Commissioner to analyze the distinctions between such corporations and those organized within the requirements of subchapter S has generated the considerable confusion now surrounding the one class of stock requirement. Although there are purposes for which debt reclassification is legitimate in the case of a subchapter S corporation, they are limited. The prevention of tax avoidance is, of course, always a valid goal for the Commissioner. If the use of debt rather than equity is solely for the purpose of gaining impermissible tax advantages, it should be reclassified in the subchapter S and ordinary corporate situations alike. The doctrine should also be applied to insure compliance with the congressional policy underlying the one class of stock requirement.

#### A. Prevention of Tax Avoidance

The underlying purpose behind the development of the doctrine of debt reclassification was the prevention of the avoidance of the double tax imposed on corporate income. Reclassification was allowed only when, under the

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139 Amory Cotton Oil Co. v. United States, 72-2 U.S. Tax Cas. 85,775 (5th Cir. 1972).
140 See Bravenec, *supra* note 3, at 231.
141 468 F.2d 572 (5th Cir. 1972). The *Shores* opinion pointed out that the statute spoke only in terms of "stock," although the regulations referred to "capital." It was in this respect that the regulations went beyond the scope of the statute, and thus rendered them invalid.
142 See notes 64-70 *supra*, and accompanying text.
143 See M. Lore, *supra* note 2, at 33.
144 See note 63 *supra*, and accompanying text.
totality of the circumstances, it was clear that the only purpose in labeling the advance as debt, rather than equity, was to conceal the true substance of a contribution to the risk capital of the business. Thus, some element of tax avoidance has always been considered a prerequisite to debt reclassification.  

The most common avoidance purpose, the double tax on corporate income, is not present in subchapter S situations, of course, since exemption from all tax at the corporate level is the very essence of subchapter S. Assuming that there are no specific tax avoidance motives, the desire to obtain the tax advantages available under subchapter S is not an impermissible tax avoidance, even if there is no other business purpose for the election than tax minimization.  

Given the prerequisite of a finding of a tax avoidance motive before debt reclassification, the doctrine should not be automatically applied any time there is a showing of thin capitalization. An inquiry should first be made into whether a tax benefit did in fact accrue, and whether the debt was intended to achieve such a result. If the purpose for the use of the debt was to accomplish impermissible tax avoidance, reclassification is legitimate. Absent such a purpose, however, the shareholders should be allowed to finance their corporation as they see fit. Assuming debt has been improperly used in an attempt to achieve impermissible tax avoidance, and such debt has been reclassified as equity, does it necessarily follow that the reclassified equity must be considered a second class of stock? All the courts which have considered the issue have held that it should not. The only advantages the parties could have been seeking through the use of debt rather than equity are those which arise from its unique character: deductibility of interest to the corporation; non-income status or repayment to the debtholder; protection from the accumulated earnings tax. Once the debt has been reclassified as equity, that unique character is lost. Going a step further and treating the equity as a second class of stock can do no more to prevent tax avoidance. Its only effect is disqualification of the corporation for election under subchapter S, a result wholly unrelated to the question of tax avoidance and equally unrelated to its prevention.

See generally M. Lore, supra note 2; Caplin, supra note 2; Schlesinger, "Thin" Incorporations: Income Tax Advantages and Pitfalls, 61 Harv. L. Rev. 50 (1947); Note, supra note 65.

Three of the major tax avoidance motives present in an ordinary corporation do not apply at all to a subchapter S corporation: (1) classifying distributions as interest rather than dividends; (2) deduction of payments as cost of goods sold rather than dividends; (3) classifying advances as loans for purposes of the bad debt deduction.


See, e.g., note 77 supra, and accompanying text. The question of the burden of proof becomes pertinent at this point. The court in Catalina took the position that the burden was on the taxpayer to show that there was no tax avoidance motive in the use of debt. 23 CCH Tax Ct. Mem. at 1367. This places on the taxpayer the burden of disproving every conceivable tax avoidance motive, even though the Commissioner either cannot or does not identify a single tax benefit arising from the use of the debt rather than equity. Such a position is unprecedented and unjustifiable. There is no basis for assuming that under subchapter S advances which are in reality equity, but treated as debt, will automatically generate favorable tax consequences. If tax avoidance is recognized as an essential prerequisite of debt reclassification, the burden of proof should be on the Commissioner to show that the taxpayer would receive an impermissible tax advantage from the use of debt rather than equity.
B. Compliance with the Single Class of Stock Requirement

A second conceivable purpose for debt reclassification is to insure that the intent of Congress in imposing the one class of stock requirement is carried out. It is arguable that a corporation which in reality does not meet the qualifications for election under subchapter S should not be allowed to circumvent congressional intent by juggling the names of its securities. When used to prevent this end, the goal of debt reclassification is different from when preventing tax avoidance. The tests to be applied must likewise be different. The criterion should be that if the use of debt rather than equity in some way contravenes the purpose behind the one class of stock requirement, the debt will be reclassified not only as equity, but as a second class of stock as well. The problem thus centers around a determination of the congressional purpose. As previously discussed,14 Congress' purpose seems to have been twofold. The difficulty anticipated by the 1954 Senate Report5 was that the distribution of preferred stock dividends in excess of current earnings and profits would make it possible for the preferred shareholders to receive income previously taxed to the common shareholders as UTI. The income would thus be taxed twice unless a deduction were allowed to the common shareholders, which would be extremely difficult where the common stock had been transferred in the interim.

These fears are largely groundless. There is no basis for an assumption that the dividends paid on a second class of stock would necessarily come from the common shareholders' PTI accounts. The amount of cash on hand available for distribution from PTI might be reduced, but the balance shown in the account itself would remain unchanged. Even assuming that the PTI balances would be reduced, it does not necessarily follow that the common shareholders must be allowed a deduction. The Code provides for a number of other ways in which tax free withdrawal from the PTI account can be forfeited,15 none of which are compensated for by deduction. A partial transfer of a shareholder's common stock does not affect the PTI account, and a complete transfer destroys it altogether. Finally, if the PTI account were reduced and a corresponding deduction allowed the shareholder, no problem would arise. Moreover, these difficulties, if present, would not furnish support for debt reclassification, for if a problem exists at all, it exists regardless of whether the debt is bona fide or concealed equity.

Another problem anticipated by the Senate was the potential complexity involved in passing corporate earnings through to a widely diversified group of shareholders.152 When there is but a single class of stock, the computation of each shareholder's individual income is very simple. When, however, there are multiple classes of stock, with varying rights and representing varying contributions to risk capital, it would be impossible for the Commissioner to allocate accurately the percentage of income and losses attributable to each share. However, use of shareholder debt, to whatever degree, creates no such

14 See text accompanying notes 18-21 supra.
151 See text accompanying notes 31-35 supra.
problems. Assuming the debt to be in reality concealed equity, and subject to reclassification in a normal corporation to prevent tax avoidance, it in no way follows that it need be deemed as constituting a second class of stock. There will be no complexities of allocation or administration if the Commissioner merely ignores the debt in allocating income and losses among the shareholders.

Alternatively, the income and losses could be allocated solely according to the amounts contributed to capital, including reclassified debt. Since other rights and interest, such as voting rights and liquidation or dividend preferences, need not be taken into account, the Commissioner would encounter no administrative complexities. In fact, it would seem to be much less of a burden than many other allocations the Commissioner is called upon to make.153

IV. CONCLUSION

The only legitimate purpose of debt reclassification under subchapter S is the prevention of impermissible tax avoidance schemes. If corporate debt is used to accomplish such impermissible ends, it should unquestionably be reclassified as equity. Being considered as equity for these purposes, however, does not necessarily require that the purported debt be considered as equity for all purposes. There is no logical basis for requiring that all equity automatically be stock equity. Furthermore, the legitimate purposes of reclassification can be completely satisfied without considering the reclassified debt as a second class of stock.Treating the equity as stock equity will go no further in preventing tax avoidance nor avoid any complexities of administration or allocation whatsoever. The only conceivable result in deeming reclassified equity in subchapter S corporations as giving rise to a second class of stock, would be to thwart the clear intent of Congress by arbitrarily and unnecessarily denying the benefits of subchapter S to a corporation otherwise entitled to their enjoyment.

153 See, e.g., INT. REV. CODE of 1954, § 1375(c). Under the provisions of that section, the Commissioner may apportion corporate earnings among shareholders who are also members of the same family “in order to reflect the value of services rendered to the corporation by such shareholders.” Id.

154 The logical solution to this as well as other problems under subchapter S is seen by many to be in congressional reform. See generally, Pennell, Subchapter S—The Need for Legislation, 24 TAX LAWYER 249 (1971). The confusion among the bar, the Service, the courts, and the electing corporations themselves could best be cleared by an authoritative word from Congress that the purposes of subchapter S are not such as to be compatible with the application of the doctrine of debt reclassification to give rise to a disqualifying second class of stock. If the one class of stock requirement is merely a rule of administrative convenience, Congress should expressly provide that the shareholders’ designation of an advance as debt or equity is determinative for purposes of classes of stock.

An excellent source of legislative proposals to meet the problems in subchapter S can be found in a series of papers published in 3 HOUSE COMM. ON WAYS AND MEANS, COMPRENDIUM OF PAPERS ON BROADENING THE TAX BASE (TAX REVISION COMPENDIUM), H.R. DOC. NO. 47060, 86th Cong., 1st Sess. 1711-48 (1959). Although these papers were submitted in 1959, only a year after subchapter S was enacted, it was already becoming clear that the provision was in need of reform in certain respects. These papers contain many worthy proposals for dealing with the one class of stock requirement and its ramifications.