SUBCHAPTER S AND SELECTED PROBLEMS IN CLOSE CORPORATION PLANNING

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There are three principal organizational structures for the conduct of business activity: the corporation, the partnership, and the sole proprietorship.[1] Each organizational form is subject to a different legal regime supposedly premised on the different nature and requirements of each particular structure. The Internal Revenue Code, too, applies a different tax regime to each form of business.[2] But these three categories are not in themselves homogeneous, either from a tax or from a business point of view. This is particularly true with respect to the corporate form of business organization, which embraces not only one-man and family corporations, but also multinational giants with tens of thousands of investors, thousands of employees, and hundreds of managerial personnel.[3] In terms of economic realities, the corporation is thus a "variable concept."[4] The law of business associations has long been plagued by problems arising from attempts to apply the law of corporations, which developed primarily to regulate and meet the needs of corporations with diversified ownership and centralized management, to the so-called "close" corporation, whose characteristics[5] and needs[6] were often quite

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[1] Of course, there are also other forms of business organization, such as the limited partnership, business trust, joint venture, and professional association.

[2] Partnerships are taxed pursuant to the provisions of Subchapter K of the Internal Revenue Code. INT. REV. CODE OF 1954, §§701-71. Corporations (except electing small business corporations) are taxed pursuant to Subchapter C, INT. REV. CODE OF 1954, §§301-95. Sole proprietorships are not subject to any specialized provisions.

[3] *See* Vagts, *The Multinational Enterprise: A New Challenge for Transnational Law*, 83 HARV. L. REV. 739 (1970).

[4] 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §41B.01 (rev. ed. 1967).

[5] For a description of the close corporation, see F. O'NEAL, CLOSE CORPORATIONS §1.07 (1958):

> A close corporation typically has the following attributes: (1) the shareholders are few in number, often only two or three; (2) they usually live in the same geographical area, know each other, and are well

different.[7] There has been a growing recognition of the distinctive needs and characteristics of the close corporation by courts[8] and state legislatures,[9] and the Model Business Corporation Act,[10] which has been used as a basis for the drafting of corporation statutes in over thirty states,[11] contains numerous provisions intended to meet the special needs of close corporations.[12]

For a long time the provisions of the Internal Revenue Code gave rise to particularly troublesome tax problems for the close corporation. When a small business incorporated to limit the liability of its shareholders, to facilitate the legal continuation of the enterprise, to enable its principals to obtain employee status, or to effect some other legitimate purpose, the corporate entity became subject to the corporate income tax. Income which had previously been taxed only once when a business was operated as a sole proprietorship or partnership was now taxed twice, first at the corporate level and then at the shareholder level. While in some cases the corporate scheme of taxation is desirable, for example, for a high tax-bracket small businessman who wishes to accumulate income in the corporation for reinvestment and eventual distribution to himself at capital gains rates, it is quite possible that a small businessman

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acquainted with each other's business skills; (3) all or most of the shareholders are active in the business, usually serving as directors or officers or as key men in some managerial capacity; and (4) there is no established market for the corporate stock, the shares not being listed on a stock exchange or actively dealt in by brokers; little or no trading takes place in the shares.

[6] For a discussion of the general corporate characteristics considered disadvantageous in a closely held enterprise, *see* 1 F. O'NEAL, *supra* note 5, at §1.12; *see also* Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation,* 1969 U. ILL. L. F. 1.

[7] *See* 1 F. O'NEAL, *supra* note 5, at §1.12.

[8] Holman-O.D. Baker Co. v. Pre-Design, Inc., 104 N.H. 116, 179 A.2d 454 (1962); Kauffman v. Meyberg, 59 Cal. App.2d 730, 140 P.2d 210 (1943); Chambers v. Beaver-Advance Corp., 392 Pa. 481, 140 A.2d 808 (1958); Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964).

[9] Latty, *The Proposed North Carolina Business Corporation Act,* 33 N.C.L. REV. 26 (1954); Folk, *The Model Act and the South Carolina Corporation Law,* 15 S.C.L. REV. 275 (1963); Hetherington, *Trends in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961,* 1963 WISC. L. REV. 92; Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes,* 1968 DUKE L.J. 525; Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation,* 54 GEO. L.J. 1145 (1966).

[10] The version used for this article is contained in ABA-ALI MODEL BUS. CORP. ACT ANN. 2D (1971).

[11] *Id.* at §1 ¶¶ 2 and 3; §1 ¶¶ 2 and 3 (Supp. 1973).

[12] See p. 25 *infra.*

in a lower tax bracket who wishes to take out all or most of the current earnings of the business will be severely disadvantaged by this double taxation.

The idea of providing some form of tax assistance to small business had been under consideration by the Treasury Department since 1946,[13] and had received presidential support in 1954.[14] In his 1954 Budget Message to Congress, President Eisenhower recognized the tax problems faced by small businessmen and made two proposals:[15]

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active shareholders be given the option to be taxed as partnerships and that certain partnerships be be given the option to be taxed as corporations.

The House Ways and Means Committee excluded both proposals from H.R. 8300, the bill which eventually became the Internal Revenue Code of 1954, but both proposals were later inserted by the Senate Finance Committee.[16] In conference, however, section 1351, the provision which would have allowed certain corporations to elect to be taxed as partnerships, was dropped. But section 1361, the provision allowing partnerships and proprietorships to elect to be taxed as corporations, was retained.[17]

Interest in permitting partnership tax treatment for certain corporations was revived in 1957, and in 1958 sections 1371 to 1377 were added to the Internal Revenue Code.[18] As finally enacted, Subchapter S

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[13] For a discussion of the post-war Treasury Department Studies, *see* D. CRUMBLEY & P. DAVIS, ORGANIZING, OPERATING AND TERMINATING SUBCHAPTER S CORPORATIONS 15-17 (1971).

[14] Annual Budget Message to the Congress, January 21, 1954, PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES—DWIGHT D. EISENHOWER, 1954, §14 at 96 (1960).

[15] *Id.*

[16] In adding these provisions the Senate Finance Committee noted:

> Your committee has adopted new provisions which for the first time will eliminate the effect of the Federal tax laws on the form of organization adopted by certain small businesses. This is accomplished by giving certain corporations the option to be taxed as a partnership and by allowing certain proprietorships and partnerships the option to be taxed as a corporation.

REPORT OF THE COMMITTEE ON FINANCE, S. REP. No. 1622, 83d Cong., 2d Sess. 118; 3 U.S. CODE CONG. & AD. NEWS 4752 (1954).

[17] For the 1954 legislative background, *see* 7 J. MERTENS, *supra* note 4, at §41B.01, and D. CRUMBLEY & P. DAVIS, *supra* note 13, at 14-18.

[18] Subchapter S (§§1371-77) was added to the Internal Revenue Code by section 64 of the Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1606, as part of a package of reforms intended to aid small businesses.

differed significantly from the earlier proposals of President Eisenhower and the Senate Finance Committee. Rather than allow eligible corporations the option to be taxed as partnerships, Subchapter S "preserved the corporate character for tax purposes" and provided for a passthrough of corporate income and losses to the shareholders.[19] While the method adopted by Subchapter S differed from the original proposal, the ultimate goal remained the same: to permit the small businessman "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."[20] Although the elimination of tax at the corporate level and the passthrough of income and losses to shareholders bear a resemblance to the scheme for the taxation of partnerships, there are significant differences which should not be overlooked.[21]

While the principal purpose behind the enactment of Subchapter S was to eliminate tax considerations in the choice of a legal form for conducting business, the actual effect of Subchapter S has been quite different. In addition to the partnership and the corporation, the businessman must now consider a third form of operation: the Subchapter S corporation. And since Subchapter S abounds in traps for the uninformed and the inattentive, "its utilization may boomerang in the absence of careful planning, followed by constant surveillance and review."[22]

The basic scheme of Subchapter S has already been thoroughly explained and discussed,[23] and there is an extensive literature dealing with particular Subchapter S problems.[24] It is the purpose of this article to

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[19] United States v. Richardson, 469 F.2d 349, 351 (10th Cir. 1972). *See also* John E. Byrne 45 T.C. 151, *aff'd* Byrne v. Comm., 361 F.2d 939 (7th Cir. 1966); Wilhelm v. United States, 257 F. Supp. 16 (D. Wyo. 1966).

[20] REPORT OF THE COMMITTEE ON FINANCE, S. REP. NO. 1983, 85th Cong., 2d Sess. 87; 3 U.S. CODE CONG. & AD. NEWS 4876 (1958).

[21] *See* Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program,* 46 VA. L. REV. 61 (1960); Dixon, *Partnership and Subchapter S: A Comparison of Tax Advantages,* 25 INST. FED. TAX 151 (N.Y.U. 1967).

[22] Moore & Sorlien, *Adventures in Subchapter S and Section 1244,* 14 TAX L. REV. 453, 457 (1959). "[B]ecause of the hybrid nature of the Subchapter S entity—not quite a corporation and not quite a partnership—the governing rules have been complex and frequently misunderstood in ways which lead to unintended hardships." U.S. TREASURY DEP'T, TAX REFORM STUDIES AND PROPOSALS, pt. 2 at 274.

[23] *See,* e.g., B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS Ch. 6 (3d ed. 1971); D. CRUMBLEY & P. DAVIS, *supra* note 13; Moore & Sorlien, *supra* note 22; Note, *Tax Planning With Subchapter S in 1967: Problems and Prospects,* 53 VA. L. REV. 1161 (1967).

[24] *See, e.g.,* Braverman, *Special Subchapter S Situations—Regulations Run Rampant,* 114 U. PA. L. REV. 680 (1966); Davis & Crumbley, *Property Distributions and Subchapter S,* 2 MEM. ST. U.L. REV. 237 (1971); O'Neill, *Literal Compliance: The IRS Weapon that Blunts Subchapter S Benefits,* 30 J. TAX. 90 (1969);

focus on recent litigation in three especially troublesome areas, where the actual requirements or effects of a Subchapter S election necessitate foresight and careful planning to enable the shareholders of an electing corporation to obtain the maximum tax advantage. These areas are corporate distributions, the net operating loss passthrough, and the single class of stock rule.

I. Distributions by Subchapter S Corporations

A. The Basic Scheme

When a normal corporation makes a distribution of money or property to its shareholders, the amount of money or the fair market value of the property are taxed as dividends to the shareholders to the extent of the corporation's current and accumulated earnings and profits.[25] The amounts so distributed have already been subject to tax at the corporate level.[26] The principal effects of a valid Subchapter S election are to exempt the electing corporation from the corporate income tax,[27] and to subject the shareholders to the provisions of section 1373, which provides for the taxation of the corporation's undistributed taxable income to the shareholders, and section 1374, which allows the net operating loss of the corporation to be deducted by the shareholders.[28] Sections 1373 and 1374 are the heart of Subchapter S. The area of corporate distributions is perhaps the most perplexing part of Subchapter S, with confusion arising from the different treatment afforded to distributions of property and money and the uncertainty concerning the source of a particular distribution. This portion of the article will consider the operation of section 1373 and its relation to the general question of distributions by a Subchapter S corporation.

Note, *New Subchapter S Hazard: The Unduly Prolonged Estate*, 23 J. Tax. 280 (1965); Calkins, *How To Use Subchapter S and Section 1244 Without Running Into Trouble*, 15 W. Res. L. Rev. 349 (1964); Note, *Shareholder Lending and Tax Avoidance in the Subchapter S Corporation*, 67 Colum. L. Rev. 495 (1967).

[25] Int. Rev. Code of 1954, §§301(b)(1)(A), 301(c)(1), 316(a).

[26] *Id.* §11.

[27] *Id.* §1372(b)(1); Treas. Reg. §1.1372-1(b)(1)(1973). In addition to its exemption from the corporate tax imposed by §11, the electing corporation is exempt from the accumulated earnings tax imposed by §531. But, the corporation becomes subject to a special tax on certain gains imposed by §1378.

[28] Int. Rev. Code of 1954, §1372(b)(2); Treas. Reg. §1.1372-1(b)(2)(1973). Another effect of a Subchapter S election on the shareholders is to deny them the dividend received exemption of §116 for actual or constructive distributions out of current earnings and profits. Int. Rev. Code of 1954, §1375(b).

When a Subchapter S corporation makes an actual distribution of money, the tax consequences to the shareholders are determined according to the rules of sections 301(c) and 316(a).[29] If the distribution is out of current or accumulated earnings and profits,[30] it is taxable to the recipient as a dividend. Actual cash distributions up to an amount equal to the current earnings and profits of the corporation are taxed as dividends, even if such distributions exceed the taxable income of the corporation.[31] Cash distributions in excess of current earnings and profits are then allocated first to distributions of undistributed previously taxed income, if any (nontaxable to the shareholder),[32] then to accumulated earnings and profits (taxable as dividends), [33] then to return of capital (nontaxable),[34] and finally to gain from the sale or exchange of property (taxable at capital gains rates).[35]

In addition to the dividend treatment of actual cash distributions if such distributions are made out of current or accumulated earnings and profits, section 1373(b) provides that each person who is a shareholder on the last day of the corporation's taxable year must include in his gross income the amount he would have received as a dividend if the corporation's undistributed taxable income (UTI) had been distributed pro rata to the shareholders on that day. The first step in determining the amount of the constructive dividend is to compute the taxable income of the corporation.[36] Next, the amount of *money* distributed *as dividends* out of

[29] Treas. Reg. §1.1372-1(c)(2) and (7). *See generally,* Davis & Crumbley, *Property Distributions and Subchapter S,* 2 MEM. ST. L. REV. 237, 238-41 (1972), *and* Cohen, *Relationship Between Provisions of Subchapter S and Subchapter C,* 20TH N.Y.U. INST. ON FED. TAX., 827 (1962). There are two exceptions to the statement that the tax consequences of actual distributions are determined under §301(c) and 316(a): where the distribution is of previously taxed undistributed taxable income pursuant to §1375(d), and where all or part of the distribution is characterized as long term capital gain by §1378.

[30] Earnings and profits are computed similarly for Subchapter S and Subchapter C purposes, except for the special rules of §1377.

[31] Current earnings and profits can exceed taxable income when the corporation has items of income which are not included in computing taxable income but which are included in computing earnings and profits, such as interest from tax exempt securities, or an excess may result when the corporation takes deductions in computing its taxable income which are not allowed in computing earnings and profits, such as deductions attributable to accelerated depreciation. *See,* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (3d ed. 1971).

[32] Treas. Reg. §1.1375-4(b) (1973); *See also* Treas. Reg. §1.1375-4(g) (1973) (example 3); *and* Randall N. Clark, 58 T.C. 94 (1972).

[33] INT. REV. CODE OF 1954, §316(a)(1).

[34] *Id.* §301(c)(2).

[35] *Id.* §301(c)(3).

[36] *Id.* §1373(d); Treas. Reg. §1.1373-1(c). In computing the taxable income of a Subchapter S corporation, deductions are not allowed for net operating losses

current earnings and profits during the taxable year is deducted from taxable income.[37] The result is the corporation's UTI for the taxable year. Then, in order to determine how much of the UTI would be taxed as a dividend if it were distributed on the last day of the corporation's taxable year, it is necessary to know the amount of the corporation's current and accumulated earnings and profits that are allocable to the constructive distributions.[38] The regulations provide that current earnings and profits are to be allocated as follows:[39]

> (1) Earnings and profits of the taxable year are first allocated to certain actual distributions of money as provided in paragraph (d) of this section. [i.e. which are not (i) in exchange for stock, or (ii) distributions of the corporation's undistributed taxable income for the immediately preceding taxable year under Section 1375(f) . . .],
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> (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
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> (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 Section 331.

It is important to note that a distribution of property does not reduce current earnings and profits in the same manner as an actual distribution of cash.[40] Current earnings and profits in excess of actual cash distributions are allocated on a pro rata basis between distributions of property and constructive dividends. This treatment of property distributions together with the rule that UTI is not reduced by distributions of property[41] may result in the shareholders being taxed on a greater amount of UTI than if an equivalent distribution had been made in cash. This may occur when the corporation has accumulated earnings and profits or when it has current earnings and profits in excess of taxable income.[42]

Each shareholder must increase the basis of his stock by the amount required to be included in his income by section 1373(b),[43] and the corporation must reduce its accumulated earnings and profits to the ex-

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or for the special corporate deductions allowed by §§241-50 (except that the deduction for organizational expenditures under §248 is allowed).

[37] *Id.* §1373(c).

[38] *Id.* §316(a).

[39] Treas. Reg. §1.1373-1(e) (1973).

[40] For an excellent discussion and specific examples *see* Note, *Shareholder Lending and Tax Avoidance in the Subchapter S Corporation*, 67 COLUM. L. REV. 495, 502-04 (1967).

[41] INT. REV. CODE OF 1954, §1373(c).

[42] *See* note 40 *supra*.

[43] INT. REV. CODE OF 1954, §1376(a); Jack Ziegelheim 26 CCH Tax Ct. Mem. 431 (1967).

tent that its UTI is required to be included in the gross income of its shareholders.[44] Thus, in effect, the corporation and its shareholders are treated as through an actual dividend had been paid by the corporation and then reinvested by the shareholders. It is this upward adjustment to basis and the downward adjustment to accumulated earnings and profits that protects the shareholders against being taxed twice on previously taxed but undistributed taxable income.[45] Since the shareholder's basis in his stock is increased by an amount equal to the previously taxed UTI, a sale of the stock will produce taxable gain only to the extent that the amount realized on the sale exceeds this augmented basis. Or, if the corporation makes distributions or has UTI in later years, the downward adjustment to accumulated earnings and profits will result in a correspondingly lower dividend to the shareholder.

B. Distributions and Tax Planning

Because of the possibility that cash distributed in excess of corporate taxable income will be taxed as dividends to the recipient shareholders if there are current or accumulated earnings and profits available for allocation to such excess, shareholder tax liability will be minimized if actual distributions are limited to corporate taxable income. This results from the fact that if actual distributions are not made, or are made in an amount less than corporate taxable income, section 1373(b) mandates constructive dividend treatment for only an amount up to corporate taxable income.[46] For example, assume that a Subchapter S corporation has taxable income of $90,000 and current earnings and profits of $100,000. If cash distributions are limited to $90,000 or less, only $90,000 will be taxed. But, if more than $90,000 is actually distributed, the shareholders will be taxed on amounts distributed up to $100,000. If the corporation has no undistributed previously taxed income but it does have accumulated earnings and profits, then actual distributions will be taxed as dividends to the extent of $100,000 plus an amount equal to the accumulated earnings and profits of the corporation.

Besides limiting actual distributions to corporate taxable income, it is also desirable to distribute *all* of the corporate taxable income, since this will eliminate later problems in extracting the undistributed previously taxed income (PTI) from the corporation. Section 1375(d) allows the shareholder to withdraw income that has previously been taxed

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[44] INT. REV. CODE OF 1954, §1377(a).

[45] *See* note 47 *infra.*

[46] *See* p. 6 *supra.*

to him under section 1373 at no further tax cost.[47] But this privilege is subject to several important qualifications. First, a distribution will not be deemed to be a distribution of PTI until all current earnings and profits have been distributed.[48] Thus, for example, a corporation with PTI of $50,000 and current earnings and profits of $100,000 cannot distribute any PTI until it first distributes its entire current earnings and profits of $100,000. Second, a distribution of property may not be deemed a distribution of PTI.[49] Third, amounts deducted from gross income by a shareholder as his pro rata portion of the corporation's net operating loss reduce his PTI account.[50] Fourth, the right of the shareholder to receive a tax-free distribution of PTI lasts only so long as the corporation's Subchapter S status remains in force.[51] And finally, the privilege of withdrawing PTI tax-free is personal to the shareholder who was previously taxed on a pro rata share of the corporation's UTI. It does not survive a sale, gift or transfer at death.[52]

But it is often impossible for the corporation to determine accurately the amount of its taxable income before the end of its taxable year.[53] To make too large a distribution may lead to increased shareholder liability, while to make too small a distribution will lead to the creation of PTI accounts. Section 1375(f) was added to Subchapter S in 1966 to remedy

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[47] *See* DeTreville v. United States, 445 F.2d 1306 (4th Cir. 1971). It is the corporation's reduction of earnings and profits under §1377 and the shareholders' increase of basis under §1376 which prevents double taxation, not the distribution provision of §1375(d). See p. 8 *supra.*

[48] Treas. Reg. §1.1375-4(b) (1973); Benderoff v. United States, 270 F. Supp. 87 (S.D. Iowa 1967), *rev'd on other grounds,* 398 F.2d 132 (8th Cir. 1968).

[49] Treas. Reg. §1.1375-4(b) (1973). This regulation was upheld in DeTreville v. United States, 445 F.2d 1306 (4th Cir. 1971) *rev'g* 312 F. Supp. 362 (D.S.C. 1970). *See* George A. Roesel, 56 T.C. 14 (1971), and Davis & Crumbley, *Property Distributions and Subchapter S,* 2 MEM. ST. L. REV. 237 (1972).

[50] INT. REV. CODE OF 1954, §1375(d)(2)(B)(i); Treas. Reg. §1.1375-4(d) (1973); *see also* Treas. Reg. §1.1375-4(g) (1973) (example 1).

[51] Randall N. Clark, 58 T.C. 94 (1972); Rev. Rul. 71-102, 1971-1 CUM. BULL. 263.

> If a new election is made subsequent to a termination under section 1372(e) of a prior election, a shareholder's net share of previously taxed income is determined *solely* by reference to taxable years which are subject to the *new* election.

Treas. Reg. §1.1375-4(d)(2)(iii) (1973) (emphasis added).

[52] Treas. Reg. §1.1375-4(e); *see also* Treas. Reg. §1.1375-4(g) (1973) (example 1 (iii)).

[53] *See* Attebury v. United States, 430 F.2d 1162, 1167 (5th Cir. 1970). Also, the corporation may not have enough cash on hand during the last month or so of its taxable year to be able to make an actual cash distribution of all its taxable income.

this situation.[54] Now the corporation has 2½ months after the close of its taxable year to distribute its UTI. Thus, it is now possible to calculate corporate taxable income with accuracy and to distribute the exact amount to shareholders. Only after the expiration of the 2½ month grace period does the UTI become subject to restrictions on withdrawal.

An important limitation on the use of section 1375(f) is that any distribution made within the 2½ month grace period must be an actual distribution of money.[55] This might prove to be a problem for a corporation which needs cash for expansion or working capital or is temporarily short of cash.[56] It is clear that if the corporation retains the cash,

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[54] *See* S. REP. No. 1007 89th Cong., 2d Sess.; U.S. CODE CONG. & AD. NEWS 2141, 2143-46 (1966).

[55] Treas. Reg. §1.1375-6(a)(2)(iii) (1973). Even a corporation whose election has been terminated may make use of §1375(f) to make a tax free distribution of its undistributed taxable income within the 2½ months following the end of its previous taxable year during which its election was in force. Treas. Reg. §1.1375-6(a)(1) (1973); Rev. Rul. 71-102, 1971-1 CUM. BULL. 263. For a distribution to qualify as a distribution of PTI, it must also be an actual distribution of money. INT. REV. CODE OF 1954, §1375(d). *See* note 49 *supra*. While the following discussion is primarily concerned with §1375(f) of the Code, it is equally applicable to §1375(d), and cases decided under that section have been utilized.

[56] A Subchapter S corporation which redeems stock may find that it is short of cash, while at the same time the tax liability of the remaining shareholders is not reduced. When a Subchapter S corporation makes a distribution of money in exchange for its stock, in a redemption which qualifies under section 302(a), UTI is not reduced by the amount so expended. This results from the fact that under section 1373(c), UTI is reduced only by the amount of money distributed *as dividends*. Furthermore, amounts distributed in redemption of stock reduce current earnings and profits only to the extent that there are current earnings and profits in excess of actual distributions of money not in exchange for stock, constructive distributions of money, or actual distributions of property. Thus, if a Subchapter S corporation's current earnings and profits do not exceed its taxable income, a redemption of stock during its taxable year will not reduce UTI *or* current earnings and profits. As a result, the tax burden of those persons who are shareholders on the last day of the corporation's taxable year will be unaffected by the redemption. Assume, for example [Treas. Reg. §1.1373-1(g) (1973) (example 5)], that a Subchapter S corporation has current earnings and profits and taxable income of $100,000. It has no accumulated earnings and profits. During the taxable year the corporation distributes $50,000 in a redemption that qualifies under section 302(a). Since the amount spent to redeem the stock does not reduce UTI, UTI remains at $100,000. And, as the current earnings and profits of $100,000 are first allocated to the constructive distribution of $100,000, the full $100,000 is includable in the gross income of persons who were shareholders on the last day of the corporation's taxable year.

A recent case, Gordon A. Erikson, 56 T.C. 1112 (1971), illustrates the difficulties which this result may cause and indicates that, in arriving at stock redemption prices, tax factors should not be neglected. Erikson owned 250 of the 600 shares of corporate stock outstanding. In 1965, in a transaction held to be a redemption

even though its shareholders receive the right to obtain the cash on demand, that such an attempted constructive distribution will not be deemed to be a distribution for the purposes of section 1375(f).[57] A distribution of demand promissory notes will likewise not be deemed to be a distribution of money,[58] nor will the issuance of checks by the corporation qualify as a distribution if surrounding circumstances indicate that the checks are not to be cashed immediately but are to be held as demand promissory notes.[59]

But what if the corporation borrows the amount needed to make a full cash distribution of its taxable income in the year it is earned (or within the 2½ month grace period), pays the borrowed cash to the shareholders, and the shareholders then lend the money back to the

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by the Tax Court, the corporation purchased all of Erikson's stock. Erikson was thus entitled to treat the receipt "as a distribution in part or full payment in exchange for the stock." INT. REV. CODE OF 1954, §302(a). He was taxed at capital gains rates on the amount he received in excess of his basis in the redeemed stock. The remaining shareholders, *i.e.*, those persons who were shareholders on the last day of the corporation's taxable year, were required to report as income their pro rata shares of UTI, and Erikson, because of the "last day" rule, escaped taxation on any part of the corporation's earnings for the taxable year of the corporation during which the stock was redeemed. *See also* Henry H. Renard, 31 CCH Tax Ct. Mem. 1210 (1972).

A Subchapter S election may be made at a time when the corporation is contemplating liquidation, even if it is insolvent. Matter of Novo-Plas Mfg. Co., Inc., 61-2 U.S. TAX CAS. ¶ 9572 (E.D. N.Y. 1961), *aff'd sub nom.* Hauptman v. Director of Internal Revenue, 309 F.2d 62 (2d Cir. 1962). Such an election will be valid for all purposes. For an example of a liquidating distribution by a Subchapter S corporation, *see* Treas. Reg. §1.1373-1(g) (1973) (example 6).

In certain situations, an election under Subchapter S by a liquidating corporation will be advantageous. *See* A. CHOKA, BUYING, SELLING, AND MERGING BUSINESSES 137-38 (3d ed. 1969); W. CASEY, CORPORATE PLANNING, ¶ 62,671 (1965); Odmark, *A Practitioner's Guide to Subchapter S Planning Opportunities and Pitfalls,* 30 J. TAX. 360 364 (1969); Note, 17 J. TAX. 63 (1962). Some examples of specific instances when a Subchapter S liquidation will be helpful are: (1) when the corporation is not able to complete its liquidation within the twelve month period dictated by section 337; (2) under Subchapter S capital gains from the sale of corporate assets may be spread over a period of years by the use of installment reporting; (3) losses resulting from the sale of section 1231 assets may be passed through to the shareholders as capital or ordinary losses; and (4) if there is section 1245 or 1250 recapture, a Subchapter S election will avoid double taxation. *See* Bickford, *Special Liquidations Other Than Under Section 337,* 13 W. RES. L. REV. 265, 269 (1962); *See also* Gardner, *The Impact of Sections 1245 and 1250 on Corporate Liquidations,* 17 U. FLA. L. REV. 58 (1964).

[57] *See* Attebury v. United States, 430 F.2d 1162 (5th Cir. 1970) *and* McKelvy v. United States, 478 F.2d 1217 (1973), dealing with analogous situations. But *see* Zimco Electric Supply Co., 30 CCH Tax Ct. Mem. 878 (1971).

[58] Randall N. Clark, 58 T.C. 94 (1972).

[59] C. D. Fountain, 59 T.C. 696 (1973).

corporation? Will this be treated as a distribution of cash, or will the transaction be integrated, with the result that the distribution will be deemed to be one of property? This problem came before the Tax Court in *George A. Roesel.*[60] *Roesel* involved an attempted distribution of PTI, which, according to the regulations,[61] must be made in money, not property.[62] In *Roesel,* the corporation wanted to make a cash distribution of $345,000 to its shareholders, but the funds available were insufficient. To enable distribution, the corporation borrowed $150,000 from a bank. The corporation then issued its checks totaling $345,000 to the shareholders, and the shareholders deposited the checks immediately. But, since the corporation still could not cover the outstanding checks, it issued notes and debentures to its shareholders in return for their checks totaling $117,500. These checks were immediately deposited by the corporation, and because they were sufficient to cover the overdraft, none of the corporation's checks were dishonored. The Commissioner argued that the corporation made a money distribution of only $227,500 and a property distribution of notes ($50,000) and debentures ($67,500). The Tax Court upheld the Commissioner:[63]

> [T]he economic substance of a transaction must govern for tax purposes rather than the time sequence or form in which such transaction is cast.
>
> . . . .
>
> [T]he purported distributions and loans were but parts of interrelated transactions which must be viewed as such for tax purposes.
>
> . . . .
>
> [S]ome portion of each check was issued pursuant to an understanding that notes and debentures would be substituted therefor.

It should be noted that the Commissioner did not challenge the bank borrowing. Thus it would appear that, if the corporation borrows from a third party lender the money needed to make a distribution of taxable income, PTI, or UTI within the 2½ month grace period, the distribution will qualify as an actual cash distribution. If a shareholder or shareholders guaranteed a loan to the corporation, though, the arrangement might be open to attack on the ground that, in substance, the transaction amounted to a loan by the bank to the shareholders and that the corporation did not actually make a distribution at all. But the success of this line of attack appears unlikely unless the corporation was thinly capitalized.[64] If the third party loan to the corporation is bona fide, the

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[60] 56 T.C. 14 (1971).

[61] Treas. Reg. §1.1375-4(b).

[62] *See* note 49 *supra.*

[63] 56 T.C. at 25-26. *See also* DeTreville v. United States, 455 F.2d 1306 (4th Cir. 1971).

[64] In Murphy Logging Co. v. United States, 239 F. Supp. 794 (D. Or. 1965), *rev'd,* 378 F.2d 222 (9th Cir. 1967), the government argued that a shareholder-

fact that it is guaranteed by shareholders should not prevent the distribution of the loan proceeds to shareholders from being treated as a distribution of money.[65]

The facts in *Roesel* most damaging to the shareholder's contention that he had received a cash distribution were, first, the insufficiency of corporate deposits to cover the checks and, second, the proximity in time of the alleged cash distributions and the shareholder loan-backs. At this time, it is unclear how far the Commissioner will go in attempting to apply the *Roesel* case in other pay-out loan-back situations. The recent case of *McKelvy v. United States*[66] seems to indicate, however, that taxpayers must proceed with considerable caution. In *McKelvy,* a Subchapter S corporation issued checks totalling $22,917.91 to its shareholders. At the time, the balance in the corporate checking account was $21,695.22. Upon receipt by the shareholders of the corporation's checks, the shareholders endorsed them and deposited them in the corporation's checking account to the extent of $22,750. The amounts so deposited were treated by the parties as loans from the shareholders to the corporation. No notes were given by the corporation to evidence these loans. In spite of the fact that the amount on deposit in the corporation's checking account was only slightly less than the checks issued, the Court of Claims had no trouble in finding the distribution to be one of property, rather than cash. Citing *Roesel,* the court said: "Looking to the substance of the transaction rather than its form and viewing this series of interrelated steps as an intergrated whole, what we have is not a distribution of money, but, rather, the distribution of corporate obligations."[67] It seems likely, then, that even if the corporation does have sufficient funds on deposit in its checking account to cover the checks issued, this fact will not be sufficient for a distribution to pass muster as one of money if the shareholder loan-back is made contemporaneously with the pay-out.[68]

Consider the following hypothetical situation. A corporation borrows funds from a bank to make cash distributions to its shareholders. The corporation distributes the cash, and sometime thereafter the shareholders

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guaranteed loan by a bank to a corporation was, in substance, a loan by the bank to the shareholders. The government based its argument on its contention that the corporation was thinly capitalized and that it was extremely unlikely that a bank would have made a loan of such magnitude to such a corporation. The district court agreed with the government. The court of appeals reversed on the ground that the corporation was not thinly capitalized, but the court did not challenge the government's basic theory of restructuring the transaction. *See also* Ackerson v. United States, 277 F. Supp. 475 (W.D. Ky. 1967).

[65] *See* Paul G. Cornelius, Sr., 58 T.C. 417 (1972).

[66] 73-1 U.S. TAX CAS. ¶ 9433 (1973); *See also* Mock, *Subchapter S Distribution Rules and Recent Developments,* 57 A.B.A.J. 929 (1971).

[67] 73-1 U. S. TAX CAS. ¶ 9433 at 81.040.

[68] *But see* Zimco Electric Supply Co., 30 CCH Tax Ct. Mem. 878 (1971).

loan an equivalent amount of money back to the corporation, receiving notes from the corporation in return. The corporation then repays the bank loan. Under *Roesel* and *McKelvy,* it would appear to be open to the Commissioner to assert that in reality the shareholders received a distribution of corporate notes or property, rather than money. But, if the shareholders could show that the indebtedness of the corporation to the bank was bona fide, and that the corporation did in fact assume the risk of non-repayment,[69] even for a short period of time, this attack might not be successful.

A problem similar to that raised by the pay-out loan-back is posed by the pay-out purchase. In this variation, the corporation makes a cash distribution to its shareholders followed by shareholder purchases of property from the corporation. In *DeTreville v. United States,*[70] the corporation issued checks to its shareholders, and one week later the shareholders purchased property (stock in another corporation) from the corporation, giving their checks in payment. In holding that the transaction was a distribution of property, the Fourth Circuit said: "The checks, amounting to 50 times the bank balance available to pay them, served only to conceal the true nature of the transaction . . . . [e]very stockholder did purchase a proportionate amount of stock, as must have been anticipated considering the woeful insufficiency of the company's bank account had any of the checks been presented for payment."[71]

II. Net Operating Loss Passthrough (Section 1374)

A. Operation and Limitations

A principal advantage of a Subchapter S election is that it allows a person who is a shareholder at any time during the corporation's taxable year to deduct his pro rata share of the corporation's net operating loss.[72] The loss is deductible from the shareholder's gross income for his taxable year in which, or with which, the taxable year of the corporation ends,[73] and since the loss is considered to be a loss arising out of the trade or business of the shareholder,[74] it is fully deductible against

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[69] *See* Leslie Q. Coupe, 52 T.C. 394 (1969), *acquiesced in* 1970-2 Cum. Bull. xix. In *Coupe,* the Tax Court held that the assumption of a real economic risk, although for only a short period of time and apparently only to comply with certain tax formalities, resulted in such compliance.

[70] 445 F.2d 1306 (4th Cir. 1971).

[71] *Id.* at 1308.

[72] Int. Rev. Code of 1954, §1374.

[73] *Id.* §1374(b).

[74] *Id.* §1374(d)(1).

ordinary income and may be carried back or forward pursuant to the provisions of section 172.[75] If a valid Subchapter S election is not in effect for the taxable year in which a corporation experiences a net operating loss, the shareholder cannot make direct use of the loss to reduce his personal income tax; instead, he can only obtain a tax benefit by selling his stock for an amount less than his adjusted basis, and, unless the stock is section 1244 stock,[76] the loss will be a capital loss.[77]

With a fledgling small business, the person or persons investing capital may often reasonably anticipate business losses in the early years.[78] For this reason, the investor may prefer to operate the business as a sole proprietorship or partnership so as to obtain an immediate tax advantage from business losses. But where the corporate form is desirable or necessary, a loss passthrough may be obtained only by electing Subchapter S treatment. Or, if an established corporation foresees an extraordinary operating loss for one or more years, it may also want to elect Subchapter S treatment for the anticipated loss period. In 1969, approximately 35% of all Subchapter S returns were filed by corporations reporting no net income.[79]

A shareholder's portion of the electing corporation's net operating loss is calculated pro rata on a daily basis.[80] Thus, a shareholder who owns 20% of the stock of an electing corporation for the entire taxable year of the corporation is able to deduct 20% of the corporation's net operating loss. If the shareholder owns 20% of the stock for only one-quarter of the taxable year of the corporation, he would be able to deduct only 25% of 20%, or 5%, of the corporation's net operating loss. It should be noted that the corporation's net operating loss for its entire taxable year is spread ratably over the entire year, and is not attributed to the particular portion of the year when the loss actually occurred. This may complicate matters when stock in a Subchapter S corporation is sold, since the amount of the loss, if any, which the seller is entitled to deduct will be uncertain until the last day of corporation's taxable year.

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[75] *Id.* §172(d)(4).

[76] *Id.* §1244. Even if the stock is §1244 stock, the maximum amount allowed as an ordinary loss for any taxable year is $25,000, or $50,000 for married taxpayers filing jointly. *Id.* §1244(b).

[77] The amount of capital loss which can be used in a taxable year is limited to the extent of that year's capital gain plus, in most cases, $1,000. *Id.* §1211(b)(1)(B).

[78] *See generally* Young, *Income Tax Consequences of Investment Losses of Individuals,* 27 TAX L. REV. 1 (1971).

[79] IRS, STATISTICS OF INCOME: 1969 BUSINESS INCOME TAX RETURNS 171 (1972).

[80] INT. REV. CODE OF 1954, §1374(c)(1).

There is one important limitation on the amount of operating loss which a shareholder may deduct. According to section 1374(c)(2) the amount of the net operating loss allowable as a deduction may not exceed the shareholder's total investment in the corporation[81] (the sum of the adjusted basis of the shareholder's stock in the corporation plus the adjusted basis of any indebtedness of the corporation to the shareholder). If the shareholder's pro rata share of the corporation's net operating loss exceeds the sum of his adjusted basis in his stock and debt, the excess is lost forever to him as a deduction.[82] It is thus critical for the shareholder to structure his dealings with the corporation so as to enable him to use any net operating loss deduction, and not to run afoul of the limitation imposed by the adjusted basis requirements of section 1374(c)(2).

The basis of a shareholder's stock in an electing corporation is determined according to the normal rules governing basis. If the stock was purchased, basis will be cost;[83] if the stock was acquired by inheritance, basis will be fair market value at the date of death or the alternate valuation date;[84] if the stock was acquired for cash or property in conjunction with the incorporation of a sole proprietorship or partnership, basis will usually be equal to the sum of the cash and the adjusted basis of the property contributed.[85]

Section 1376 provides special rules for adjustments to basis of stock in an electing corporation. Under section 1376(a), the basis of a shareholder's stock must be increased by the amount of money required to be included in his gross income but which is not actually distributed to him. Under section 1376(b)(1), the basis of a shareholder's stock must be reduced by the portion of the corporation's net operating loss which is attributable to his stock.

While the net operating loss limitation and its relationship to the basis rules appear relatively straightforward, several recent cases indicate that there are pitfalls to be avoided. In *George W. Wiebusch,*[86] for example,

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[81] *Id.* §704(d). This section provides a similar limitation on the deductibility of partnership losses.

[82] Treas. Reg. §1.1374-1(b)(4)(i) (1973). Besides being lost to the shareholder, the loss does not aid the corporation, since under §172(h), in determining a corporation's net operating loss, "there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S." INT. REV. CODE OF 1954, §172(h); *see also* Roberts v. Comm'r 398 F.2d 340 (4th Cir. 1968), *cert. denied,* 393 U.S. 936 (1968).

[83] INT. REV. CODE OF 1954, §1012.

[84] *Id.* §1014.

[85] *Id.* §358.

[86] 59 T.C. 777 (1973), *aff'd,* 73-2 U.S. TAX CAS. ¶ 9797 (1973).

a sole proprietorship was incorporated in 1964, and the newly formed corporation elected to be taxed under Subchapter S. The assets transferred to the corporation had a fair market value of $292,975 and an adjusted basis of $119,219. The corporation also assumed liabilities in the amount of $180,441. The corporation incurred net operating losses in 1964, 1965, and 1966, and the shareholders sought to deduct these losses. The Tax Court held, however, that the transferor was required to determine his basis in his stock according to section 358, and that since under that section his basis was zero,[87] he was unable to take any deduction because of the limitation imposed by section 1374(c)(2).

In *Donald M. Perry,*[88] a partnership, anticipating a large loss on a government contract, incorporated so as to insulate the partners from personal liability, and then elected Subchapter S treatment in order to make use of the net operating loss passthrough. Perry and his wife had a basis of $39,000 in their stock, but prior to the end of the corporation's taxable year, they caused the corporation to transfer to them land that had an adjusted basis in excess of $47,000. Since the corporation did not have any current or accumulated earnings and profits on the last day of the taxable year of the transfer, Perry and his wife realized a return of capital under section 301(c). The basis of their stock was thus reduced to zero, and they were unable to utilize any of the corporation's net operating loss. A similar result was reached in another case,[89] where the forgiveness by a Subchapter S corporation of an indebtedness owed to it by a shareholder was treated as a distribution of property, and since the shareholder was unable to prove that the distribution was out of current or accumulated earnings and profits, there resulted a reduction of the basis of the shareholder's stock, greatly reducing his net operating

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[87] The taxpayer in *Wiebusch,* under a §351 exchange, had a recognized gain on the transfer to the extent that the liabilities transferred exceeded his adjusted basis in the property transferred to the corporation. INT. REV. CODE OF 1954, §357(c)(1). Furthermore, by virtue of the assumption of liabilities and the concomitant recognition of gain, the taxpayer's basis in his corporate investment became zero. Section 358(a)(1) provides the formula for computing his basis:

$119,219.08	Basis of property exchanged
— 180,441.33	Liabilities assumed (money)
+ 61,222.25	Gain recognized
0	

Under §358(a)(1) the taxpayer's basis in his investment is the same as his basis in the property exchanged *minus* "money received" (§358(d) deems the assumption of liabilities to be money) *plus* the amount of gain recognized.

[88] 49 T.C. 508 (1968).

[89] Jack Haber, 52 T.C. 255 (1969), *aff'd,* 422 F.2d 198 (5th Cir. 1970).

loss deduction for one year and eliminating it for three subsequent years.[90] Finally, the burden of proof is on the shareholder to establish his basis in his stock.[91]

B. Shareholder Loans

Shareholder loans to electing corporations have proved considerably more troublesome, probably because the shareholder loan is more amenable to taxpayer manipulation. For example, if a shareholder sees that the corporation is likely to have a net operating loss for its taxable year, and his total basis in his stock and debt is less than his pro rata share of the loss, he can increase his basis by lending more money to the corporation. In order for the shareholder to obtain a basis step-up from a loan to the corporation, however, the indebtedness must be an "indebtedness of the corporation to the shareholder."[92] Thus, a loan to an electing corporation by an estate of which a shareholder was the sole beneficiary did not serve to increase the shareholder's basis, since the indebtedness did not run directly from the corporation to the shareholder. The Tax Court held that the estate and the beneficiary-shareholder must be treated as separate legal entities.[93] The same result was reached where a partnership[94] and where a trust[95] made loans to electing corporations.

If the loan transaction lacks economic reality, a deduction may be denied. In *William H. Perry,*[96] the shareholder, owner of 2,999 of the electing corporation's 3,000 shares, issued a demand note to the corporation and, in return, received a long term note for the same amount. The transaction was held not to be a "corporate indebtedness" entitling the shareholder to increase his basis in order to utilize the corporation's losses as deductions. The *Perry* court stated that an "actual economic outlay" was necessary and that the corporation's "long-term 'indebtedness' left . . . [the shareholder] economically unimpaired, both actually and constructively."[97] In *Silverstein v. United States,*[98] two shareholders attempted to increase their basis by transferring notes to the electing cor-

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[90] *See also* John E. Byrne, 45 T.C. 151 (1965), *aff'd,* 361 F.2d 939 (7th Cir. 1966); *and* Herbert Levy, 46 T.C. 531 (1966).

[91] Donald J. Sauvigné 30 CCH Tax Ct. Mem. 123 (1971).

[92] INT. REV. CODE OF 1954, §1374(c)(2)(B).

[93] Ruth M. Prashker, 59 T.C. 172 (1972) (the court rejected taxpayer's contention that the attribution rules of §267 should apply).

[94] E. J. Frankel, 61 T.C. No. 38 (1973); Rev. Rul. 69-125, 1969-1 CUM. BULL. 207.

[95] Robertson v. United States, 73-2 U.S. TAX CAS. ¶ 9645 (D. Nev. 1973).

[96] 54 T.C. 1293 (1970), *aff'd,* 71-2 U.S. TAX CAS. ¶ 9502 (8th Cir. 1971).

[97] *Id.* at 1296.

[98] 349 F. Supp. 527 (E.D. La. 1972).

poration in exchange for proportional amounts of stock. The transaction took place three days before the end of the tax year; none of the principal had been paid and only an insignificant interest payment had been made over a six year period. Citing *Perry,* the court found that there had been no "actual economic outlay" and that there was no discernible business purpose behind the issuance of additional stock by the corporation. On those facts and because the "only purpose of the transaction was to increase basis in order to create a vehicle to take a deduction,"[99] the court disallowed the shareholders' deductions.

The court's approach in *Silverstein* resembles closely the analysis used in *Goldstein v. Commissioner.*[100] The taxpayer in *Goldstein* sought to offset her substantial windfall income (sweepstakes winnings) by deducting interest costs incurred in a series of loan transactions. The court concluded that there was no profit motive behind the loans and that the transactions lacked "all substance, utility, and purpose,"[101] except for the generation of interest deductions under section 163 of the Internal Revenue Code:[102]

> [T]his provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction. . . .

Although *Goldstein* dealt with the section 163 interest deduction provision, while *Silverstein* involved the net operating loss passthrough of section 1374, it is possible that *Silverstein* could be extended by the *Goldstein* analysis to prevent any increase in a shareholder's basis, regardless of "economic outlay," when the only motive is the "tax benefit."[103]

Similarly unsuccessful have been attempts by shareholder-employees to defer the receipt of salaries and to treat the money owed as corporate indebtedness which thereby increases the shareholders' basis. In refusing to recognize the validity of deferred salary indebtedness, the courts[104] have pointed out that the performance of services by a cash basis taxpayer, without the reporting or realizing of income, is not the kind of "cost" necessary for basis adjustments.

The "indebtedness of the corporation to the shareholder" language of section 1374(c)(2)(B) has been litigated most often in situations where an electing corporation obtained a loan from an outside lender,

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[99] *Id.* at 530.

[100] 364 F.2d 734 (2d Cir. 1966), *cert. denied,* 385 U.S. 1005 (1967).

[101] *Id.* at 742.

[102] *Id.* at 741-42.

[103] *Cf.* Knetsch v. United States, 364 U.S. 361 (1960).

[104] *See* George W. Wise, 30 CCH Tax Ct. Mem. 169 (1971); Joe E. Borg, 50 T.C. 257 (1968).

but the loan was guaranteed by a shareholder. The shareholder then argues that he is entitled to include in the adjusted basis of his corporate debt an amount equal to the corporate loan he has guaranteed. Such claims have met with total rejection.[105] The Tax Court summarized its position in *Milton T. Raynor:*[106]

> No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation. Prior to that crucial act, "liability" may exist, but not debt to the shareholders.

In a recent case,[107] a shareholder in an electing corporation tried a new approach. He contended that shareholder guaranteed loans made by a bank to the corporation were in reality loans from the bank to the shareholder followed by a capital contribution to the corporation by the shareholder. The Tax Court accepted the shareholder's argument that the court should look to substance rather than to form, but concluded that "petitioner simply . . . has not convinced this Court that the guaranteed loans should properly be characterized as equity investments."[108]

If a shareholder wants to obtain an increased basis for a loan by a third party to the corporation, the only sure way of accomplishing this is for the shareholder to borrow the money himself and to lend it to the corporation. If the loan takes the form of an advance by the shareholder to the corporation, it appears that the source of the funds will be disregarded.[109] In many instances of third party loans to corporations, the lender is primarily interested in obtaining a guarantee by a shareholder or shareholders, so that he can proceed against them directly and not be limited to the corporate assets. In such cases, a loan to the shareholder or shareholders, followed by a loan by them to the corporation would accord with business needs and allow the shareholders to obtain a basis step-up for purposes of taking advantage of the corporation's net operating loss. If the third party lender wants the additional protection of being able to proceed against the corporation, it would seem that this could

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[105] William H. Perry, 47 T.C. 159 (1966), *aff'd* 392 F.2d 458 (8th Cir. 1968); Joe E. Borg, 50 T.C. 257 (1968); Milton T. Raynor, 50 T.C. 762 (1968); Neal v. United States, 313 F. Supp. 393 (C.D. Cal. 1970); Wheat v. United States, 353 F. Supp. 720 (S.D. Tex. 1973); Eleanore H. Smalley, 32 CCH Tax Ct. Mem. 373 (1973).

[106] 50 T.C. 762, 770-71 (1968); *see also* Rev. Rul. 70-50, 1970-1 CUM. BULL. 178, and Rev. Rul. 71-288, 1971-2 CUM. BULL. 319.

[107] Peter E. Blum, 59 T.C. 436 (1972); *see also* Murphy Logging Co. v. United States, 239 F. Supp. 791 (D. Or. 1965).

[108] 59 T.C. at 440.

[109] Paul G. Cornelius, Sr., 58 T.C. 417 (1972).

be worked out by having the corporation guarantee the loan made to the shareholders.[110]

If the shareholder does make loans to his electing corporation for the purpose of increasing his adjusted basis in order to take full advantage of his pro rata share of the corporation's net operating loss, he might incur tax liability when the corporation repays the loans. Under section

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[110] *See geneally* Kreidmann, *The Corporate Guaranty*, 13 VAND. L. REV. 229 (1959) *and* Dwyer, *A Legal and Business Examination of the Contractually Supported Investment in Relation to the Corporate Guaranty*, 23 SYRACUSE L. REV. 33 (1972). While the Model Business Corporation Act apparently allows corporate guarantees of loans to officers or directors, there may remain some uncertainty as to ultimate corporate liability for such loans. ABA-ALI MODEL BUS. CORP. ACT ANN. 2D §4(h) (1971) provides:

> Each corporation shall have power:
>
> . . . .
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> (h) To make contracts and guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises and income.

A prior, more specific subsection of the Act grants the corporation power:

> (f) To lend money and use its credit to assist its employees.

Despite the powers conferred by the Model Act, in view of the Act's recent heritage, corporate guarantees may still face problems. Initially, such guarantees were deemed *ultra vires* where the corporation was acting solely to accommodate the borrower and received no direct benefit. *See* Brinson v. Mill Supply Co., 219 N.C. 498, 14 S.E.2d 505 (1941). Even where state statutes allow corporate guarantees, stockholder objection may invalidate the arrangement. *See* Real Estate Capital Corp. v. Thunder Corp., 31 Ohio Misc. 169, 287 N.E.2d 838 (1972). In order for a corporate guarantee to be upheld, in most states at least one of the following requirements should be met: (1) the guarantee should further some corporate purpose, *see, e.g.*, Medallion Tower, Inc. v. Fort Lauderdale Technical College, Inc., 323 F. Supp. 180 (E.D. La. 1970); (2) there should be ratification of the guarantee by at least a majority of the shareholders, *see, e.g.*, H.M. Popp Truck Line, Inc. v. First Nat'l Bank, 485 P.2d 141 (Colo. 1971); (3) an innocent party should be involved, for example, a creditor or holder in due course, etc.; (4) or the guarantee should be pursuant to an express provision of the articles of incorporation, *see, e.g.*, Louisville, N.A. & C. Ry. Co. v. Louisville Trust Co., 174 U.S. 552 (1899).

A corporation's defense of *ultra vires* has been restricted in some states, *e.g.*, Goodman v. Ladd Estate Co., 246 Or. 621, 427 P.2d 102 (1967), and, in other states, estoppel has been used as an enforcement device. *See, e.g.*, A.M. Castle & Co. v. Pub. Serv. Underwriters, 198 Wash. 576, 89 P.2d 506 (1939).

Many of the traditional corporate guarantee problems are not particularly troublesome in the Subchapter S context, since the small number of shareholders required by the subchapter facilitates shareholder approval. Nonetheless, unless the particular state statute empowers a corporation to make guarantees, a provision should be included in the articles of incorporation to prevent other debtholders from successfully challenging the transaction.

1376(b)(2), the basis of the shareholder's debt is reduced by an amount equal to the portion of the corporation's net operating loss allocated to him under section 1375(c)(1). When the corporation repays the debt, then, the shareholder will have taxable gain. Thus, assume that a 100% stockholder paid $10,000 for stock in an electing corporation. The corporation later experiences a $15,000 operating loss. Anticipating the loss, the shareholder makes a $5,000 loan to the corporation so that he can utilize the loss in its entirety. His total adjusted basis in stock and debt is now $15,000 and he is able to deduct $15,000 on his individual return. The next year the corporation repays the $5,000 loan. The shareholder now has a $5,000 gain.[111]

As a general rule, the gain received by the taxpayer (in the foregoing example, $5,000) will constitute capital gain and will be taxed at the preferential rates. As explained in Revenue Ruling 64-162,[112] this treatment is afforded by virtue of section 1232(a)(1) of the Internal Revenue Code. Of course, any interest component of the loan repayment would be taxed as ordinary income. To insure the capital gain treatment of gains realized on loan repayments, it has been suggested that the corporation should issue a note as evidence of the debt.[113] Where loans are made to the corporation on an open account the repayments would have to be "allocated in part to a return of . . . basis in the loan and in part to income, but the income is ordinary income and not income from the exchange of a capital asset."[114] The different treatment afforded to note redemptions and open account repayments is based on the technical capital asset requirements of section 1232(a)(1) of the Code.[115]

Despite the ordinary income treatment of gains realized on the repayment of open account loans, the open account arrangement does provide the shareholder with an option seemingly not available when individual notes are issued as evidences of corporate indebtedness. With an open account a shareholder may be able to maintain or increase his basis in the total indebtedness by aggregating his loans to the corporation to compute a "lump sum" basis in the debt. In this way the shareholder would be able to decrease or minimize the amount of gain actually realized when the corporation repays the loans. In figuring gain, then, the shareholder is allowed to include all advances made to the corporation, the

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[111] Paul G. Cornelius, Sr., 58 T.C. 417 (1972); Joe M. Smith, 48 T.C. 872 (1967), *aff'd and rev'd,* 424 F.2d 219 (9th Cir. 1970).

[112] 1964-1 CUM. BULL. 304.

[113] D. CRUMBLEY & P. DAVIS, *supra* note 13, at 78.

[114] Rev. Rul. 68-537, 1968-2 CUM. BULL. 372.

[115] *See also,* Note, *Shareholder Lending and Tax Avoidance in the Subchapter S Corporation,* 67 COLUM. L. REV. 495, 519 (1967) This excellent Note explains why the capital gain treatment does not provide a tax "loophole" to the Subchapter S shareholder.

"total indebtedness," as elements of his basis. This approach was expressly approved in *Novell v. Commissioner*.[116] The *Novell* court held that, in the open account situation, the Commissioner must include all advances made by the creditor-shareholder in computing basis:[117]

> We think that the fraction of any payments in . . . [the tax year] which represents income should have as its numerator the difference between the face amount of the *total indebtedness* to the shareholder and the shareholder's basis therein and as its denominator the total indebtedness. By "total indebtedness" we mean the aggregate of the balances of [the] Accounts . . . at the time of such payments.

In sharp contrast to the *Novell* approach is *Paul G. Cornelius, Sr.*[118] In *Cornelius* the taxpayers, Subchapter S shareholders, had loaned $215,000 to the corporation in 1966. The loan was repaid in April, 1967, and the court held that the taxpayers were liable for the gain realized on the repayment (each shareholder's basis had been reduced by prior operation of the loss passthrough provisions). The taxpayers argued that the gain computations should be made with reference to the total indebtedness for the year. In rejecting this contention,[119] the court held that the $215,000 loan and subsequent repayment was a "completed transaction" and that "loans occurring later in 1967 were separate and apart from such transactions."[120] It appears that the *Novell* rationale was not applicable to *Cornelius* for two reasons: first, the relatively prompt repayment of the total loan was a "long standing policy of the business;"[121] and second, perhaps more importantly, it seems that the *Cornelius* shareholders did not make additional advances to the corporation until *after* the outstanding loan account had been fully repaid.[122] Hence, to avoid the "completed transaction" principle of *Cornelius*, a shareholder loan, on an open account, should be made before the corporation discharges its outstanding indebtedness to the shareholder.

At least two questions, the answers to which are beyond the scope of this article, are raised by a comparison of *Novell* and *Cornelius*. Under the *Cornelius* analysis, is *total* repayment necessary to deem the transaction "completed," or will partial repayment be sufficient to isolate the

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[116] 29 CCH Tax Ct. Mem. 92 (1970), *modifying* 28 CCH Tax Ct. Mem. 1307 (1969).

[117] *Id.* at 93.

[118] 58 T.C. 417 (1972).

[119] The *Cornelius* court also rejected the shareholders' contention that the loans to the corporation should be treated as investments, and that §316 of the Code should govern their repayment, *i.e.*, that the distribution should be treated as a dividend only to the extent of the corporation's current and accumulated earnings and profits, and that the excess should be treated as a return of capital. *Id.* at 421-22.

[120] 58 T.C. at 423.

[121] *Id.*

[122] *Id.* at 422.

existing indebtedness from subsequent advances? In other words, should the *Cornelius* shareholders have preserved enough outstanding debt to characterize the account as "open"? The other question involves the use of notes in an attempt to take advantage of the *Novell* reasoning. Assume, for example, that a Subchapter S shareholder has loaned money to the corporation and holds a note as evidence of the indebtedness. The shareholder then makes another loan to the corporation, cancels the first note, and, in return, receives a note evidencing both loans. Would the shareholder not only be allowed to use the *Novell* "total indebtedness" approach in computing any subsequent gain, but also be afforded capital gain treatment on such gain because of the utilization of the note, a capital asset?

Possibly underlying the schemes and contentions of the shareholders in *Novell* and *Cornelius* is an attempt to avoid the effects of section 1376(a) of the Code: if the shareholder's total investment in the corporation is increased by an amount equal to his pro rata share of UTI, he may only increase the basis in his stock, and *not* his debt. By limiting the effect of UTI to upward adjustments in the basis of stock only, the present law makes it virtually impossible for the shareholder to "rebuild" his basis in debt, which may have been reduced through the individual deduction of net operating losses.[123] Because of the relatively short term status of his debt investment, as opposed to his stock investment, the shareholder, even though he was able to offset net operating losses against his basis in debt, is then faced with certain and immediately foreseeable taxable gain[124] when the corporation repays the loan. There is no apparent reason for precluding the restoration of shareholder basis in debt.[125] Given the choice between an upward adjustment of stock basis or debt basis, it is clear that the Subchapter S shareholder would opt for the latter. Possibly as a concession to shareholder preference, and in recognition of the fact that loans to Subchapter S corporations are simply another form of investment, the Treasury Department has proposed a revision of the basis adjustment rules.[126] Under the proposed rules, if the shareholder has reduced his basis of debt in the corporation, any sub-

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[123] *See.* p. 14 *supra.* Under the right circumstances, of course, the shareholder may be able to increase his basis in total debt by making additional loans to the corporation. *See* p. 19-23 *supra.*

[124] It may be of some solace to the shareholder that this gain is generally taxed at capital gains rates. *See* p. 22 *supra.*

[125] One commentator has noted: "Omission of positive basis adjustment to shareholder debt can be explained only as an oversight." White, *Recurring and New Problems Under Subchapter S,* 27 N.Y.U. 27th INST. ON FED. TAX. 755, 783 (1969).

[126] U.S. TREAS. DEP'T, TAX REFORM STUDIES AND PROPOSALS, 91st. Cong., 1st Sess. 287 (Comm. Print 1969).

sequent increase in basis (by proration of UTI) is first applied to the debt basis to the extent of its prior reduction.[127] The remaining increase would then be applied to the shareholder's basis in stock. Thus, under the proposal, while debt basis is the last item to be reduced it is the first to be "rebuilt".[128]

III. THE ONE CLASS OF STOCK RULE: SECTION 1371(a)(4)

The Model Business Corporation Act[129] provides the small business planner with considerable flexibility for the effectuation and satisfaction of the corporate shareholder's particular needs and desires. If the corporation is a "close corporation,"[130] its business may be managed by its shareholders, rather than by a board of directors;[131] and if certain procedures are followed, corporate decisions may be made by the informal action of directors (or shareholders acting in the place of directors).[132] Various control devices which are particularly useful in the close corporation setting are authorized, thus eliminating much prior confusion and uncertainty. Voting trusts,[133] irrevocable proxies,[134] shareholder agreements restricting the transfer of shares,[135] and shareholder voting

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[127] *Id.*

[128] It should be noted that the new rule is justified in part, if not completely, by other proposals which would require ordinary income treatment for shareholder gains attributable to the reduction of basis in debt. Thus, unless a shareholder completely terminates his interest in the corporation, his gain on the disposition of debt would be taxed as ordinary income to the extent of the reduction reflected in his basis for debt (or to the extent of corporate earnings and profits, if lesser). *Id.* The reason for the proposal rule is explained:

> This rule prevents the possibility of converting income into capital gain by holding a portion of a subchapter S interest in the form of debt, reducing the basis of such debt by subchapter S losses, and then after the election is terminated redeeming the debt at a time when a partial stock redemption would be treated as a dividend.

Id. at 290. This proposal is complemented by the rule which provides for the restoration of basis in debt. *See* Note, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 824 (1971).

[129] *See* note 10 *supra.*

[130] *See* note 5 *supra.*

[131] ABA-ALI MODEL BUS. CORP. ACT ANN. 2D §35 (1971). This section provides that a corporation is to be managed by its board of directors "except as may be otherwise provided in the articles of incorporation."

[132] *Id.* §§44 and 145.

[133] *Id.* §34.

[134] *Id.* §33.

[135] *Id.* §54.

agreements[136] are specifically endorsed, and rules governing their use are prescribed. Dissolution pursuant to court order is made considerably easier,[137] and courts are empowered to grant relief other than formal dissolution.[138] Finally, the law concerning preemptive rights recognizes the particular needs of the close corporation.[139] While Subchapter S is an invaluable planning tool for the close corporation, the prerequisites for Subchapter S treatment restrict to some extent the utility of certain of the control devices authorized by the Model Act. Furthermore, obtaining and retaining Subchapter S eligibility may unduly complicate capital structure and estate planning for the individual shareholder. This portion of the article will explore the scope and impact of the subchapter's single class of stock requirement upon certain corporate control devices.[140]

A. Close Corporation Control Devices and Subchapter S

Only a "small business corporation," as defined in section 1371(a),[141] is eligible to make an election to be taxed under the provisions of Sub-

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[136] *Id.* §60.

[137] *Id.* §§83-87 and 97.

[138] *Id.* §§98-103.

[139] *Id.* §§26, 26A.

[140] This article will not deal with the problems associated with the reclassification of debt in Subchapter S corporations. Until quite recently, the Internal Revenue Service maintained that under certain circumstances, if shareholder debt was reclassified as equity, a second class of stock was created. Treas. Reg. §1.1371-1(g) (1973). After two decisions to this effect, Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964), and Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965), however, this position has been flatly rejected by the courts, W.C. Gammon, 46 T.C. 1 (1966); James L. Stinnett, Jr., 54 T.C. 221 (1970); Estate of Allison, 57 T.C. 174 (1971); Shores Realty Co., Inc. v. United States, 468 F.2d 572 (5th Cir. 1973); Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972); Portage Plastics Co. v. United States, 470 F.2d 308 (7th Cir. 1973). In T.I.R. No. 1248, July 27, 1973, the Internal Revenue Service announced that:

> [I]t will propose amendments to Income Tax Regulation Sec. 1.1371-1(g) relating to the disqualification for Subchapter S treatment of corporations having more than one class of stock. Pending revision of the regulation, the IRS will not litigate the issue of whether Subchapter S obligations which purport to represent debt, but which actually represent equity capital, constitute a second class of stock. . . .

7 CCH 1973 STAND. FED. REP. ¶6754.

[141] For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not

(1) have more than 10 shareholders;

(2) have as a shareholder a person (other than as an estate) who is not an individual;

chapter S;[142] likewise, an electing corporation's eligibility is automatically terminated if the corporation ceases to be a "small business corporation."[143] Two prerequisites for qualification as a "small business corporation" have proved especially troublesome for shareholders of a close corporation who desire Subchapter S treatment: the provision that only individuals or estates may be shareholders and the requirement that the corporation have only one class of stock. The former requirement, for instance, precludes the estate planning option of funding intervivos or testamentary trusts with corporate stock if the shareholders wish to retain Subchapter S eligibility.[144] This restriction could be highly important to the shareholder whose net worth consists primarily of stock in the corporation. The Treasury proposals suggest certain modifications,[145] but do not materially alter the present scheme.

The one class of stock requirement[146] has proved considerably more vexing, for what appears to be a rather straightforward rule has been

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(3) have a nonresident alien as a shareholder; and
(4) have more than one class of stock.

INT. REV. CODE OF 1954, §1371(a).

[142] *Id.* §1372(a).

[143] *Id.* §1372(e)(3).

[144] *See* Fulk & Needham, Inc. v. United States, 288 F. Supp. 39 (M.D.N.C. 1968), *aff'd,* 411 F.2d 1403 (4th Cir. 1969). *See also* Old Virginia Brick Co., Inc., 44 T.C. 724 (1965), *aff'd,* 367 F.2d 276 (4th Cir. 1966). Income splitting by gifts of stock is somewhat of a problem because according to §1375(c):

> Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b) (may be apportioned or allocated by the Secretary or his delegate between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 704(e)(3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

See Henry D. Duarte, 44 T.C. 193 (1965); Walter J. Roob, 50 T.C. 891 (1968); Michael F. Beirne, 52 T.C. 210 (1969); Charles Rocco, 57 T.C. 826 (1972); Pat Krahenbuhl, 27 CCH Tax Ct. Mem. 155 (1968).

[145] U.S. TREAS. DEP'T, TAX REFORM STUDIES AND PROPOSALS, 91st Cong., 1st Sess. 275-76 (Comm. Print 1969).

[146] Treas. Reg. §1.1371-1(g) (1973) states:

> In determining whether a corporation has more than one class of stock, only stock which is issued and outstanding is considered. Therefore, treasury stock and unissued stock of a different class than that held by the shareholders will not disqualify a corporation under section 1371(a)(4).

See also Rev. Rul. 67-269, 1967-2 CUM. BULL. 298: ". . . the mere issuance of [stock] options, warrants, and convertible debentures would not affect a corporation's eligibility to make an election under section 1372(a) of the Code."

interpreted by the Internal Revenue Service broadly enough to make Subchapter S treatment practically unavailable to close corporations that use certain control devices.[147] Although the courts have generally rejected the Service's position,[148] and the Service has thus been forced to adopt certain modifications,[149] the one class of stock rule as it affects the availability of close corporation control devices still places an unwarranted restraint on legitimate corporate planning. And although it might seem that the courts have gone as far as possible, given the language of section 1371(a)(4), decisional law[150] offers some hope that the single class rule may be redefined by judicial construction. Nonetheless, since the application of section 1371(a)(4) in certain circumstances furthers no valid legislative purpose, the section should be amended by Congress.[151]

Although the legislative history of the one class of stock rule is sketchy, the rule apparently was inserted to insure that electing corporations remain essentially equivalent to partnerships or proprietorships, and also to avoid complexities in allocating the earnings and net operating losses of a corporation to its shareholders under the passthrough provisions of sections 1373 and 1374.[152] The regulation[153] promulgated by the Treasury

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[147] Treas. Reg. §1.1371-1(g) (1973); Rev. Rul. 63-226, 1963-2 CUM. BULL. 341.

[148] *See* Parker Oil Co., Inc., 58 T.C. 985 (1972), *and* A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S.D. Ohio 1967).

[149] Rev Rul. 73-611, I.R.B. 1973-53, 56.

[150] Samuel Pollack, 47 T.C. 92 (1966), *aff'd*, 392 F.2d 409 (5th Cir. 1968).

[151] The Treasury proposals, *supra* note 145, are a step in the right direction, since they call for an amendment which would allow small business corporations to have outstanding stock with differences in voting rights, whether such rights are created by corporate charter or by shareholder agreement.

[152] The only clear expression of the legislative intent behind §1371(a)(4) is disclosed by the Senate Finance Committee comments on portions of the 1954 Code which were not adopted at that time, but which were the predecessors of Subchapter S. On the subject of the one class of stock limitation, the Committee noted:

> The corporation may have only one class of stock outstanding. No class of stock may be preferred over another as to either dividends, distributions, or voting rights. If the requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an adjustment, however, would be extremely difficult where there had been a transfer of common stock in the interim.

S. REP. NO. 1622, 83d Cong., 2d Sess. 453-54; 3 U.S. CODE CONG. & AD. NEWS 5097 (1954).

interpreting the one class of stock provision, however, is unduly rigid and goes far beyond the statutory purpose:[154]

> If 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. Thus a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation.

The Service's position with respect to voting rights was elaborated in Revenue Ruling 63-226,[155] in which it ruled that a corporation which had only one class of stock outstanding did not qualify as a "small business corporation" because of a shareholder agreement in which active shareholders were granted irrevocable proxies by inactive shareholders:[156]

> Because of the restrictions placed upon the inactive shareholders under the agreement . . ., it is held that their rights and interests in the control of the corporation are not identical with the rights and interests of the active shareholders. Furthermore, 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.

The planning device used by the shareholders in Revenue Ruling 63-226 served the valid corporate purpose of insuring that control of the business was vested in those shareholders engaged in the active conduct of the business. Scrutinized in the light of the apparent legislative purpose be-

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In A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S. D. Ohio 1967), the government argued that differences in the value of stock occasioned by different voting rights were significant as a rationale of the one class of stock rule. 271 F. Supp. at 44. Although this argument was not expressly rejected in that case (there was no need to do so since all the shares were subject to the voting trust), it is untenable. *See* Rev. Rul. 73-525, I.R.B. 1973-48, 13: a corporation amended its certificate of incorporation to provide that all shareholders over the age of 65, owning not less than 10 shares of stock for more than 5 years, and having a medical need of a nursing home, were entitled to admission to the corporation's nursing home at a reduced rate. Although this provision had the effect of enhancing the value of certain shares and not others, it was held not to create a second class of stock.

[153] Treas. Reg. §1.1371-1(g) (1973).

[154] *Id.; see generally,* Comment, *Voting Rights and the Single Class of Stock Requirement of Subchapter S,* 10 HOUS. L. REV. 869, 870-72 (1973).

[155] 1963-2 CUM. BULL. 341.

[156] *Id.* 342.

hind the one class of stock rule, the arrangement is manifestly unobjectionable. There is no sound reason why a close corporation using this sort of planning device should be denied a Subchapter S election. The corporation would still retain its character as an "incorporated partnership," and the irrevocable proxies would not alter the relative rights of the shareholders to actual or constructive distributions, net operating loss passthroughs, and liquidation proceeds. Furthermore, the Service was not compelled by regulation 1.1371-1(g) or by section 1371(a)(4) itself to hold that the irrevocable proxy arrangement created a second class of stock since the corporate charter, by its terms, established only a single class of stock.[157] The Service should not have adopted a substance-over-form approach unless the legislative purpose of the statute would be furthered by such an analysis.

In subsequent litigation involving the effect of dissimilar voting rights on Subchapter S eligibility, a rather clear pattern has emerged. If two or more classes of stock are created by the corporate charter itself, even though the classes are identical except for differences in voting rights, courts have been constrained to hold that the corporation is ineligible for Subchapter S treatment.[158] But, if the corporation has only one class of stock outstanding, the corporation is eligible for Subchapter S treatment even though its shareholders have structured arrangements which effectively give disproportionate voting power to certain shareholders.[159]

The emphasis on formal classification is well illustrated in the case of *Samuel Pollack*.[160] In *Pollack,* the corporate charter authorized the issuance of four classes of stock. Classes A and B consisted of 33⅓ shares each, and classes C and D consisted of 16⅔ shares each. The classes were identical in all respects, except for the right of each class to elect one director. Because the power to elect directors was not proportionate to the number of shares in each group, the "groups of shares" exception of regulation 1.1371-1(g) to the one class of stock rule was held unavailable. Basing its decision on a provision of state law which provided that a corporation could issue only those shares authorized by its charter, and noting that the charter expressly authorized the issuance of four classes, the *Pollack* court held that the corporation had more than one class of stock and was thus not a "small business corporation."[161]

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[157] *See* Parker Oil Co., Inc., 58 T.C. 895, 991 (Featherstone, J., concurring).

[158] *See e.g.*, Samuel Pollack, 47 T.C. 92 (1966); Barnes Motor & Parts Co. v. United States, 309 F. Supp. 298 (E.D.N.C. 1970).

[15] *See* Parker Oil Co., Inc., 58 T.C. 895 (voting trust). A. & N. Furniture & Appliance Co.[9] v. United States, 271 F. Supp. 40 (S.D. Ohio 1967) (voting trust).

[160] 47 T.C. 92 (1966).

[161] A similar result was reached in Barnes Motor & Parts Co. v. United States, 309 F. Supp. 298 (E.D.N.C. 1970), on the ground that the two outstand-

In its attempt to clarify the "groups of shares" exception to section 1371(a)(4) referred to in the Treasury regulations,[162] the *Pollack* court noted that merely "nominal"[163] classes of stock would not run awry of the single class of stock requirement. The defect in the Pollack voting arrangement was that the right to elect directors was not proportionate to the number of shares in each "group" or class. If, however, each of the four classes of stock authorized by the corporate charter had been comprised of the same number of shares (and each class could elect one director), the court apparently would have approved of the arrangement. In such a case, the stock classification could properly be characterized as "nominal"; the charter provisions and stock classifications would not have affected the equal voting *power* of each share but rather the manner in which that power could be exercised.

Up to this point, of course, *Pollack* only reiterates and explains the Treasury's "groups of shares" exception. However, the language in *Pollack*—"nominal" classes of stock—may provide the springboard for a future judicial decision that classes of stock which differ only as to voting rights are not contrary to the one class of stock rule, regardless of whether such classes are provided for in the corporate charter. The *Pollack* court properly recognized that share groupings, or "nominal" classes of stock, could be set out in the corporate charter with no adverse effect on Subchapter S eligibility; on that single point, *Pollack* establishes an exception to those cases[164] which seem to condemn stock classifications based on voting rights solely because the classes are created by corporate charter. Once it is accepted that the legislative purpose behind the one class of stock rule is simply to avoid accounting difficulties[165] in dividend and liquidation preferences, for example, and that the rule was not meant to prohibit practical voting arrangements, the "nominal" class label of *Pollack* might be utilized to hold that even chartered classes of stock, which vary only in voting power, do not violate the one class of stock rule.

A use of the "nominal class" label to characterize shares which differ only as to voting power (whether created by charter or shareholder agreement), is buttressed by the court's policy analysis in *A. & N. Furniture*

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ing classes of stock were both expressly authorized in the corporate charter, despite the fact that the only difference between the classes was that one was voting and the other nonvoting.

[162] [I]f two or more *groups of shares* are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock.

Treas. Reg. §1.1371-1(g) (1973) (emphasis added).

[163] 47 T.C. at 110.

[164] *See, e.g.*, Parker Oil Co., Inc., 58 T.C. 895 (1972).

[165] A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. at 45.

& Appliance Company.[166] The Subchapter S corporation in *A. & N. Furniture* issued a single class of voting common stock to its four shareholders; three of the four shareholders then surrendered their voting rights to the remaining shareholder under a ten year voting trust.[167] The Commissioner argued that the divestiture of voting power had the effect of creating two classes of stock, one voting, the other nonvoting; seemingly, the voting trust arrangement was the very type of control device condemned by regulation 1.1371-1(g) and Revenue Ruling 63-266. Undaunted, the court looked to the legislative intent and purpose to determine the effect of the voting trust on the corporation's Subchapter S status. Noting that the purpose of Subchapter S was to allow a choice of business organization, unfettered by tax considerations, the *A. & N. Furniture* court found that the single class of stock requirement was meant "to insure that only *small business*"[168] benefit from the subchapter and was intended "to eliminate great complications in accounting which otherwise might result from the election."[169] Because the voting trust neither affected corporate size nor complicated shareholder tax accounting, the court held that section 1371(a)(4) did not prohibit the use of the control device.[170]

A. & N. Furniture, then, recognizes that some corporate devices are not fatal to a Subchapter S election. By focusing on legislative purpose, *A. & N. Furniture* allows shareholder voting agreements which do not confound the computation of shareholder tax liability. The *Pollack* case, in its discussion of the "group of shares" exception to section 1371(a)(4), introduces the term, "nominal classes of stock"; if this characterization in *Pollack* is extended by reference to legislative objectives, "nominal" classes of stock, distinguished only by their relative voting rights, may yet pass muster under the single class of stock requirement.

B. The Parker Oil Case

The recent case of *Parker Oil Company, Inc.*[171] considered the question of whether an irrevocable proxy created a second class of stock. The case is more notable for the Tax Court's broad endorsement of close corporation control devices in the Subchapter S corporation than for its narrow holding that the irrevocable proxy did not amount to a

[166] 271 F. Supp. 40 (S.D. Ohio 1967).

[167] According to the shareholders, the purpose of the trust was to "insure continuity and stability of policy and management". *Id.* at 42.

[168] *Id.* at 43 (emphasis added).

[169] *Id.*

[170] In the course of its opinion, the *A. & N. Furniture* court declared Revenue Ruling 63-226 invalid, and limited the scope of regulation 1.1371-1(g).

[171] 58 T.C. 985 (1972).

second class of stock; and the ultimate conclusion to be drawn from *Parker Oil* is that voting differences, whether created by corporate charter or private agreement, are simply irrelevant in measuring a corporation's eligibility under Subchapter S.

Stock in the Parker Oil Company was owned by three individuals: one shareholder held 40 shares, another held 10 shares, and the third owned 50 shares. Pursuant to a private agreement, entered into in settlement of litigation, the shareholder owning 50 shares gave an irrevocable proxy to a third party outsider to vote 5 shares of stock. The party was also given the power to elect one of the four corporate directors. The major hurdle facing the *Parker Oil* court was the *Samuel Pollack*[172] decision. Distinguishing *Pollack* on the basis that the case involved an actual authorization of multiple classes of stock in the corporate charter, the court in *Parker Oil* held that "section 1.1371-1(g), Income Tax Regs., and Rev. Rul. 63-226 . . . are invalid to the extent that they hold a second class of stock is created unless all of the shares outstanding are identical as to all voting rights."[173] The implications of this decision are clear: if a particular control device is appropriate in the close corporation context, the device should not be deemed to create a second class of stock unless two or more classes of stock actually authorized by the charter are outstanding.[174]

Three judges[175] disagreed with the majority's position in *Parker Oil,* and two, Judges Raum and Sterrett, wrote dissenting opinions. Each

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[172] 47 T.C. 92 (1966).

[173] 58 T.C. at 990.

[174] The following statement from the concurring opinion of Judge Featherstone, in which Judges Drennen, Dawson, Tannenwald and Quealy concurred, demonstrates that we have come full circle from Revenue Ruling 63-226:

> In a real sense, closely held corporations are "essentially partnerships." As between themselves, their stockholders frequently operate the corporate business as if they were partners, working out various kinds of arrangements for managing corporate affairs. These arrangements may include, for example, agreements providing that each shareholder will vote for the other as a director, or that each will have a veto power as to the election of directors, or that shares of two or more shareholders will be pooled or voted together. These agreements are particularly useful in situations like the one in the instant case where misunderstandings which have arisen between the shareholders can be resolved only by advance arrangements as to how the directors are to be selected and how the stock will be voted.
>
> State laws have recognized the need for special arrangements between the shareholders of closely held corporations . . . I see no reason why such practical arrangements should disqualify a corporation for Subchapter S treatment.

Id. 992-93. *See also* Note, *Stockholder Agreements and Subchapter S Corporations,* 19 TAX L. REV. 391, 398 (1964).

[175] Judges Raum, Sterrett and Simpson.

thought that *Pollack* should control the disposition of the case, and that, by distinguishing *Pollack* simply on the basis that in *Parker Oil* the share classifications were not spelled out in the corporate charter, the majority had elevated form over substance. Judge Raum made the point that the voting restriction in *Parker Oil,* because "the owner of . . . [the] shares was irrevocably deprived of the right to vote his shares *in any manner*",[176] was even more "drastic" than the arrangement in *Pollack.* In his dissent, Judge Sterrett attempted to show the potential dangers of the majority's form-over-substance approach:[177]

> Further, if the shareholders may privately rearrange voting rights, what is to prevent them from rearranging the interests in the assets upon liquidation or providing for the payment of some prescribed amount to one particular shareholder, or group of shareholders, to the exclusion of others? Such an arrangement could easily be required as an inducement to secure the participation of some particularly valuable individual. Would not such an arrangement as readily thwart the purpose of Congress, as found by the majority, "to avoid complexities in taxing income to shareholders with different preferences as to the distribution of profits" as would the direct issuance of differing stock interests by the corporation? The answer must be in the affirmative.

Aside from the fact that valuable individuals may just as easily, and legitimately, be induced to participate in corporate affairs by the use of qualified corporate debt or a substantial salary, the dissent seemingly ignores the type of tax complexities which Congress meant to avoid. Essentially, the one class of stock rule was designed to insure simplicity and manageability in the tax accounting aspects of dealings between the corporation and its shareholder.[178] Complications which might arise from financial schemes between individuals are neither unique in the Subchapter S context nor are they the sort of accounting difficulties with which Congress was concerned.[179]

The Service has acquiesced in the result of *Parker Oil* and has revoked Revenue Ruling 63-226.[180] According to Revenue Ruling 73-611, if disproportionate voting rights arise from agreements among shareholders or between third parties and shareholders, the disproportion will not produce a second class of stock. But, if a disproportion in voting rights is created by the corporation's charter or articles, the corporation will be deemed to have more than one class of stock. Retention of the distinction between voting power differences which arise out of the corporate charter, on the one hand, and shareholder agreements, on the other,

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[176] 58 T.C. at 994 (emphasis added).

[177] *Id.* at 995-96.

[178] *See* A. & N. Furniture & Appliance Co. v. United States, 271 F. Supp. 40 (S.D. Ohio 1967).

[179]. *See* note 152 *supra,* and accompanying text.

[180] Rev. Rul. 73-611, I.R.B. 1973-53, 56.

makes no sense in light of the purposes to be served by Subchapter S. This duality in treatment for two situations which in reality are identical only creates another trap for the businessman who wants to elect under Subchapter S, and such treatment should be eliminated by congressional action. The benefits of Subchapter S were intended specifically for the small close corporation, and it is this very sort of corporation which may need to employ various types of voting arrangements and control devices.

IV. Conclusion

Recent developments indicate that courts are increasingly looking beyond the literal language or strained constructions of the provisions of Subchapter S in order to effectuate what they perceive to be the fundamental policies of the statute. This has not always been true. In the past courts denied taxpayers the use of Subchapter S by either insisting on a literal reading of the statute coupled with the requirement of strict compliance or by sustaining a position of the Service based on an unduly restrictive regulation or interpretative ruling. Since in several important particulars the statute and the regulations tend to frustrate unnecessarily the legislative purpose of allowing certain close corporations the option of being taxed in a manner similar to partnerships, the more liberal attitude of the courts is to be welcomed. But this heightened awareness of the courts to the policies and economic realities underlying Subchapter S cuts both ways; as recent developments also indicate, various tax minimization devices have been rejected by the courts, while others have been rendered more vulnerable to challenge. It appears, for example, that it will become increasingly difficult to manipulate corporate distributions and shareholder loans to the corporation to produce tax benefits unless substance corresponds to form. In this regard, planning problems under Subchapter S have been made even more demanding.