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Subchapter S--Shareholder Debt and the One Class of Stock Rule

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Notes

SUBCHAPTER S—SHAREHOLDER DEBT AND THE ONE CLASS OF STOCK RULE

I. INTRODUCTION

In 1958 Congress enacted legislation[1] which, at the election of the stockholders, permits corporations to forego the payment of any tax[2] and requires their shareholders to report the corporate income as their own for tax purposes.[3] The stated purpose of the legislation is to permit businesses to select the form of business organization desired without the necessity of taking into account major differences in tax consequences.[4]

For taxable years to which the election applies, the federal income tax on the corporation is eliminated.[5] However, the corporation's taxable income is taxed, whether or not distributed, to its shareholders as of the last day of the corporation's taxable year as if on such day there had been a pro rata dividend distribution of the corporation's taxable income. In order that subchapter S will operate in as simple a manner as possible, the income taxed to the shareholders is usually treated as ordinary income without regard to any special characteristics it might have had in the hands of the corporation.[6] However, there is an exception in the case of long-term capital gain income which generally passes through to the shareholder level.[7]

Only "small business corporations" are eligible to elect subchapter S treatment.[8] A small business corporation is a bona fide corporation which has no more than ten shareholders each of whom is either an individual or an estate, has no shareholder who is a nonresident alien, and has only one class of stock.[9] It is this last requirement which has resulted in some of the major tax litigation involving subchapter S corporations. One way in which litigation can arise is when the Commissioner of Internal Revenue [hereinafter Commissioner] asserts that purported debt of the corporation is, in reality, equity capital and, as

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1 INT. REV. CODE OF 1954 [hereinafter cited as IRC] §§ 1371-79.
2 IRC § 1372.
3 IRC § 1373.
4 S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958).
5 IRC § 1372(b)(1).
6 IRC § 1373.
7 IRC § 1375(a).
8 IRC § 1372(a).
9 IRC § 1371(a).

such, constitutes a second class of stock. The basis for this assertion is found in litigation involving conventional corporations, that is, corporations which have not elected the provisions of subchapter S. It is the author's purpose to explore the regulatory and judicial history of this assertion and to compare the present status of the law in this area with the stated purposes of subchapter S and the one class of stock rule.

II. SHAREHOLDER DEBT IN THE CONVENTIONAL CORPORATION

To fully understand the assertion that debt may constitute a second class of stock for a corporation electing subchapter S treatment, it is necessary to understand how shareholder debt is treated in the case of a conventional corporation. It is a common practice in the closely-held corporation for the shareholder to loan funds to the corporation in lieu of purchasing additional capital stock.[10] This practice has two distinct tax advantages. The interest paid or accrued on the debt is deductible by the corporation in determining its taxable income, and subsequent repayment of the debt will generally be tax-free to the creditor-shareholder.[11] The interest payments are taxed to the shareholder, but this is the only tax to which the payment is subjected. If the shareholders had purchased additional capital stock instead of debt obligations, however, then any payments based on such capital stock would not be an allowable deduction to the corporation in determining its taxable income. Instead, the distributions would be out of the corporation's post-tax earnings and profits. This distribution is then taxed to the shareholder as a dividend, in effect taxing the corporation's earnings twice.[12] Shareholder debt in the coventional corporation, then, is a device for eliminating this double tax.

It is not uncommon for the Commissioner to attack this arrangement and to assert that the shareholder debt is in reality equity capital.[13] Since the interest payments are not made for a valid indebtedness of the corporation the corporation is not allowed an interest deduction for the payments. Instead, the Commissioner asserts that these payments are really "disguised dividends" since they were paid on what is really equity capital.

The criteria to be used in determining whether or not the shareholder debt is in reality equity capital have been thus stated:

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[10] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS § 4.02, at 121 (2d. ed. 1966).
[11] *Id.*
[12] *Id.*
[13] *Id.* § 4.02, at 122.

> There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participating in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditors and stockholders; (10) payment of interest only out of 'dividend' money; (11) the abiltiy of the corporation to obtain loans from outside lending institutions.[14]

To this list might be added other criteria, for example, that all the initial payments, both capital and advances, were made for the acquisition of capital assets by the corporation,[15] or that they were made for the purpose of beginning the corporate life.[16] No comprehensive rule can be stated which will be applicable in all cases,[17] but the primary question to be answered in each case is whether or not the intent and acts of the parties should be disregarded in characterizing the transaction for federal tax purposes.[18]

The position which the courts have taken in determining the characterization to be given the transaction has been stated thusly:

> We cannot, by manipulation of tax law, preclude the parties from exercising sound business judgment in obtaining needed investment funds at the most favorable rate possible, whether it be a commercial loan, or, more likely . . . a loan from private interested sources with sufficient faith in the success of the venture and their ultimate repayment to delete or minimize the 'risk factor' in their rate of return. We must not forget that while the principles articulated . . . continue to furnish helpful guidelines, application of these so-called factors, or any one of them, must be tempered by an awareness that from our Commission as Judges we are not qualified, or certainly not the best qualified persons, to determine the many intricacies of transactions in the business world. Our guidance in making fact decisions and in declaring or applying legal principles must come from the enlightment afforded by an evidentiary record reflecting the facts the business world regards as significant.[19]

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[14] O. H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 125 (9th Cir. 1960).
[15] Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942).
[16] Janeway v. Commissioner, 147 F.2d 602 (2d Cir. 1945).
[17] Montclair Inc. v. Commissioner, 318 F.2d 38, 40 (5th Cir. 1963).
[18] Tomlinson v. The 1661 Corp., 377 F.2d 291, 299 (5th Cir. 1967).
[19] *Id.* at 300.

An impressive body of law has thus been developed for application to the situation where a conventional corporation attempts to avoid the double taxation of dividends through the guise of interest payments on shareholder debt.

It is this same body of law which the Commissioner has attempted to apply to a corporation electing the provisions of subchapter S. However, the underlying purpose of this body of law, to prevent corporations and their shareholders from avoiding the double taxation of dividends, is not applicable to a subchapter S corporation. Whether the payment is characterized as interest or dividend, it will reduce the corporation's undistributed taxable income. Since a shareholder of a subchapter S corporation is taxed personally on his pro rata share of the corporation's taxable income, whether or not it is distributed,[20] then he will be taxed on the same amount no matter how the payment is characterized. The foregoing statement can best be illustrated by the following example.

XYZ Corporation, an electing subchapter S corporation, had taxable income of $20,000 for the year 1969. The corporation made no distributions to its sole shareholder, *A*, during the year. However, it did pay *A* $2,000 as interest on a loan which *A* had made to the corporation. The corporation deducted the $2,000, as interest expense in arriving at its taxable income of $20,000. Since *A* is the sole shareholder of the corporation, then he will include the entire $20,000 on his personal return for 1969. He will also include the $2,000 interest payment in his personal income. *A* is thereby taxed on $22,000.

If, however, the $2,000 payment were characterized as a dividend, then the corporation would not have been able to deduct it in arriving at its taxable income. The corporation's taxable income, then, would be $22,000. *A* would still be taxed on only $22,000 since the $2,000 dividend would be a distribution to him of the $22,000 on which he was already taxed. A double tax on the dividend is thus avoided.

The underlying purpose for applying the body of law to the subchapter S corporation lies elsewhere. If the Commissioner is successful in contending that the shareholder debt really amounts to a second class of stock, then the corporation's election under subchapter S will be terminated.[21] The termination will be retroactive to the first day of the taxable year in which the second class of stock first came into existence. Thus, all income for that year and for all subsequent years will be taxed to the corporation, and any distributions

[20] IRC § 1373.
[21] IRC § 1372(e)(3).

which the corporation has made will be taxed to the shareholders as dividends. A double tax is thus imposed.

III. SHAREHOLDER DEBT IN THE SUBCHAPTER S CORPORATION

The original regulations[22] to subchapter S are illuminating on the subject of when a small business corporation has more than one class of stock. They provide as follows:

> A corporation having more than one class of stock does not qualify as a small business corporation. 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). If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest 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. However, if 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. *If an instrument proporting to be a debt obligation is actually stock, it will constitute a second class of stock.*[23] (Emphasis added).

Where purported debt is involved, the regulations contain an automatic rule that makes such purported debt a second class of stock. Thus, if the corporation fails to prove that the debt is not really equity, then the corporation's election will be automatically terminated under the regulation.

A leading case where the regulation has been applied is *Catalina Homes, Inc.*[24] There, the corporation was a newly formed real estate development company with paid-in capital of $10,000 consisting of 200 shares of no par common stock, all of which was owned by two families. Two of the shareholders entered into an agreement whereby they loaned $70,000 to the corporation over a two year period. Under the terms of the agreement interest at the rate of five percent was to be paid as determined by the corporation's board of directors. Also, no dividends were to be paid on the common stock until the loans had been paid in full.

The Commissioner contended that the loans were really equity capital, and that as such, they were a second class of stock pursuant

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[22] Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.
[23] *Id.*
[24] 23 CCH Tax Ct. Mem. 1361 (1964).

to the regulations. The corporation contended that the loans were valid corporate debt obligations because they were not held by the shareholders in the same ratio as they held the corporation's outstanding stock.

The Tax Court held that the loans were in reality a second class of stock. Among the factors which the court considered determinative of the issue were: (1) interest was not payable in any event; (2) the purported lenders never demanded or contemplated demanding repayment; (3) there were no notes or other evidence of indebtedness; (4) the corporation's original working capital was inadequate to meet the future needs of the business; and (5) all of the advances were made within five months of the date of incorporation. Also, the court pointed out that most of the income was distributed rather than used to repay the loans. These factors indicated to the court that the loans were permanent capital subject to the risk of the business.[25] The court rejected the corporation's argument, *supra*, by stating that proportionality between the amount of the purported loans and individual stock holdings is merely an "indication" that the advances constitute capital contributions.[26]

Although the Tax Court placed emphasis on the fact that the loans were made in the early months of the corporation's existence,[27] a similar decision was reached by a federal district court in *Henderson v. United States*[28] where the purported loans were made in the later years of the corporation's existence. Without citing the Tax Court's holding in *Catalina Homes, Inc.*, the court held that pro rata shareholder loans were, based on the evidence, intended to take the risks incident to a capital investment. Among the factors which the court found to be determinative were: (1) the loans were in proportion to stock ownership; (2) there was no security for the loans; (3) there was no intention to enforce the obligations in accordance with their terms; and (4) at the formation of the company the stockholders were aware that they would later be required to advance $30,000 for equipment purchases.[29]

Thus, both courts made a factual determination that the purported loans were in reality equity capital. Having reached this decision, both courts then sustained the Commissioner's contention that under the regulation the purported debt was a second class of stock. One fact stands out in each case. Both courts based their opinions

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[25] *Id.* at 1365-66.
[26] *Id.* at 1367.
[27] *Id.* at 1366.
[28] 245 F. Supp. 782 (M.D. Ala. 1965).
[29] *Id.* at 786.

on the criteria which were developed in the conventional corporation situation discussed *supra*. Neither court discussed whether these criteria were applicable to the subchapter S situation.

However, the Commissioner's victories were short-lived. In the case of *W. C. Gamman*,[30] loans by the shareholders to the corporation were far in excess of its paid-in stated capital and were, in effect, placed at the risk of the business, thus representing additional invested capital. But, when the Commissioner attempted to void the corporation's election because it had a second class of stock, the corporation contended that the regulation was invalid.

This time, the Tax Court decided in favor of the taxpayer and held that the regulation went beyond the Congressional intent and was not within the scope of the statute.[31] In so doing, the court enunciated a new rule making it a question of fact to be determined in each case whether there is additional invested equity capital as well as whether the result is a second class of stock causing the loss of subchapter S status.[32] The court said that it would look at the realities of the situation to determine whether the instrument gave the holders any rights and interests different from those of the holders of the nominal stock. It was noted that the notes were held by the stockholders in direct proportion to their stockholdings and whatever preferences they had were over themselves as stockholders. The court concluded that the notes were not true debt obligations nor were they a second class of stock, but rather contributions to capital "which were in reality reflected in the value of the common stock already held by petitioners."[33]

The court also considered the applicability of the debt-equity criteria used in the conventional corporation situation to determine whether there is more than one class of stock for purposes of subchapter S. Noting that this doctrine was developed by the courts to prevent normal corporations from avoiding the double tax by distribution of earnings in the form of interest or by repayment of loans, the court held that it did not apply to subchapter S corporations since the very purpose of the statute was to exempt them from the double tax. Since this particular corporation had no accumulated earnings, there was little in the way of unintended tax advantages to be obtained by letting the stockholders advance funds in the form of loans rather than capital.[34]

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30 46 T.C. 1 (1966).
31 *Id.* at 8.
32 *Id.* at 11.
33 *Id.* at 9.
34 *Id.* at 12.

As a result of this reversal, the regulation was amended in 1966. As amended, it states that purported debt which is in reality

> . . . equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock. But, if an issuance, redemption, sale, or other transfer of nominal stock, or of purported debt obligations which actually represent equity capital, results in a change in a shareholder's proportionate share of such purported debt, a new determination shall be made as to whether the corporation has more than one class of stock as of the time of such change.[35]

It might be paradoxical at this point to reconsider the *Henderson*[36] and *Catalina Homes*[37] cases under the new regulation. In *Henderson*, one of the factors which influenced the court's decision that the debt was really a second class of stock was the fact that the loans were held in proportion to stock ownership.[38] Thus, the corporation would probably have been victorious in this case since the current regulation would treat such loans as capital contributions rather than a second class of stock. In *Catalina Homes*, however, the change in the regulation probably would not change the result of the case. Since the corporation had contended that the loans were *not* held in proportion to stock ownership,[39] then the case could not fall under the exception in the regulation, but rather would come under the general rule which states that purported debt will generally constitute a second class of stock.[40]

However, recent cases indicate that some courts have refused to follow the new regulation when confronted with the situation where the purported debt obligations are not held in the same proportion as the nominal capital stock. In *August F. Neilsen Company, Inc.*[41] the corporation had outstanding 1,400 shares of $100 par value common stock which was held equally by the corporation's two shareholders. In addition, each shareholder held a $40,000, six percent promissory note, originally issued in 1952. Disproportionate payments were made

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[35] Treas. Reg. § 1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219, *amending* Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.

[36] Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965).

[37] Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964).

[38] 245 F. Supp. at 786.

[39] 23 CCH Tax Ct. Mem. at 1367.

[40] Treas. Reg. §1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219; *c.f.* August F. Nielson Co., 27 CCH Tax Ct. Mem. 44, 50 (1968).

[41] 27 CCH Tax Ct. Mem. 44 (1968).

on the notes, and at the end of 1958 the two notes had been reduced to $10,000 and $5,000 respectively. The Commissioner contended that the disproportionate balance of the notes resulted in the vesting in the shareholders of rights in the profits and assets of the corporation which were disproportionate to the rights and interests vested in them by the nominal stock, and therefore the notes were in the nature of preferred stock.[42]

The court concluded that the notes were not true indebtedness, but were an equity interest.[43] However, it refused to call the purported debt a second class of stock and noted that

> the regulation does not state that it shall be considered that a corporation has more than one class of stock in *every* instance where there has been a change in a shareholder's proportionate share . . . of a purported debt which actually represents equity capital.[44]

The court also concluded that even though the payments on the notes were disproportionate, there was no intention to create a preferred interest and the repayments ultimately would be equal.[45]

In *Portage Plastics Company, Incorporated v. United States*,[46] several factors led to the conclusion that purported loans actually constituted contribution to capital. Among these were the fact that interest was payable only out of profits before taxes, the loans were subordinated to certain bank loans, and there was no provision for acceleration in case of default.[47] Thus, the court followed the traditional debt-equity criteria in determining that the loans were actually equity capital. However, the court refused to follow the amended regulation[48] and call the loans a second class of stock. The court concluded

> that the traditional debt-equity tests applied in other areas of tax litigation are [not] relevant to the general purpose of subchapter S or to the two conceivable purposes of the one class of stock requirement. . . .[49]

The latter two purposes are to avoid the administrative complexities which would arise from having to allocate earnings and losses among different classes of stock and to make the election available for the

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[42] *Id.* at 49-50.
[43] *Id.* at 49.
[44] *Id.* at 50.
[45] *Id.*
[46] 301 F. Supp. 684 (W.D. Wis. 1969).
[47] *Id.* at 689-90.
[48] Treas. Reg. § 1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219, *amending* Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.
[49] 301 F. Supp. at 692.

most part to smaller type corporations.[50] The court held that in the case before it there would be no administrative difficulties unless the debt instruments were first determined to represent a class of stock.[51]

The decisions in the *Portage Plastics* and the *August F. Nielsen* cases cast serious doubts as to the applicability of the current regulation in determining whether purported debt constitutes a second class of stock. The recent case of *James L. Stinnett, Jr.*[52] confirms the inapplicability of the regulation in this situation. In *Stinnett,* the Tax Court was confronted with a corporation which had outstanding 100 shares of $1 par value stock for a total authorized capitalization of only $100. Furthermore, the corporation was indebted to its shareholders in the amount of $88,014.49. At the time of incorporation the interests of two of the shareholders represented by stock and by the notes were proportionate each to the other but disproportionate to the interests of the other two shareholders whose interests were also disproportionate each to the other.

The Commissioner contended that for tax purposes the debt represented by these notes should be regarded as equity capital, and therefore, the corporation had outstanding two classes of stock. The court conceded that the Commissioner's contention would be valid if the case involved the treatment of payments of principal and interest on account of these notes under general tax law. However, the Commissioner's contention was held not determinative of the issue in this case.

> Even accepting the [Commissioner's] argument, we would not have two clases of stock . . . .
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> The notes did not entitle the holders to any right to vote or to participate in the decision-making process. The notes did not entitle the holders to participate in any of the earnings or growth of the business, being limited solely to the repayment of the 'debt' itself without interest. . . . [I]t would be wholly unrealistic to treat these notes *standing alone* as another class of stock.
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> . . . [I]t is our opinion that regardless whether the notes in question be considered as 'debt' or as 'equity' under other provisions on the internal revenue laws, for purposes of section 1371 such notes do not change the character of the common stock so as to give rise to more than one class of stock.[53]

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50 *Id.*

51 *Id.* at 693.

52 CCH TAX CT. REP. 2327 (Dec. 29,995, 54 T.C. —, No. 20, Feb. 11, 1970).

53 *Id.* at 2331-32.

The Court then referred to its decision in *W. C. Gamman*[54] wherein the original regulation was held to be invalid and noted that the regulation had subsequently been amended. It then proceeded to invalidate the amended regulation.

> We do not regard as controlling with respect to the question whether there is more than one class of stock within the meaning of section 1371(a) the fact that 'debt' characterized as 'equity' capital may be disproportionate to the respective common stock interests of the stockholders. *Accordingly, we must hold the regulation invalid as applied to this case.* To hold otherwise not only would serve largely to defeat the purpose for which Congress enacted subchapter S, but would be inconsistent with the underlying scheme of the statute as exemplified by section 1376(b)(2). (Emphasis added.)[55]

The Internal Revenue Code of 1954, section 1376(b)(2), provides for the reduction of the shareholder's basis in his stock and indebtedness in the corporation for his portion of the corporation's net operating loss which the corporation has passed through to him under section 1374(c). The court concluded that this section treats debt owing to stockholders as a secondary equity interest and interpreted section 1376(b)(2) to be not only

> . . . a clear indication that the statute contemplates that stockholders of a subchapter S corporation would make advances or lend money to the corporation, but for the purpose of reflecting losses deducted by the stockholders in their returns, any resulting debt is treated as a part of the stockholder's 'investment.' The losses which are charged to that investment can only be attributable to the interest of the stockholder represented by the common stock. . . . [I]t thus becomes apparent that for purposes of subchapter S, the statute treats debt owing to a stockholder, whether or not regarded as equity for other purposes, as a part of that stockholder's equity interest in the corporation. Debt owing to a nonstockholder is treated differently.[56]

The court then discussed the effect which section 1376(b) could have upon stockholders' interests which were originally proportionate. This discussion can best be illustrated by an example.

Assume that *A* and *B* each own one half of the outstanding stock of *XYZ* corporation. *A* purchased his stock from the corporation when it was incorporated for $5,000, but *B* purchased his stock from *C*, who was an original shareholder with *A*, for $3,000 at the beginning

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[54] 46 T.C. 1 (1966).

[55] CCH TAX CT. REP. 2332 (Dec. 29,995, 54 T. C. —, No. 20, Feb. 11, 1970.

[56] *Id.* at 2332-33.

of current year. Also, *A* and *B* have each advanced $10,000 to the corporation in return for promissory notes. Assume further that the corporation had no earnings or losses in prior years, but that during the current year the corporation sustained a new operating loss of $30,000. Since *A* and *B* each own one half of the coropration's stock, then $15,000 of this loss is passed through to each shareholder to be reported on his personal return. Under section 1376(b), *A* and *B* must reduce the basis of their stock and indebtedness in the corporation. Thus, *A*'s basis is reduced to zero ($5,000 + $10,000 – $15,000). However, section 1376(b)(2) states that the shareholder's basis cannot be reduced below zero. Since *B's* total basis is only $13,000 he may only reduce his basis by $13,000 of the $15,000 loss. Thus, the application of section 1376(b) has resulted in a disproportionate right in the losses of the corporation.

The court then observed that a capital structure consisting of stock and shareholder loans is merely a means by which a shareholder who does not have the necessary capital is able to reinvest his share of the corporation's income and thereby repay funds advanced by the other shareholders in the form of loans. The court concluded that since this type of transaction was contemplated by and is the normal result of the operation of the statute, it is reasonable to assume that Congress did not intend that a debt owing to a stockholder be considered as a second class of stock under the "thin capitalization" doctrine where the instrument is a simple installment note without any incidents usually attributed to stock "merely because it creates disproportionate rights among the stockholders to the assets of the corporation."[57]

IV. CONCLUSIONS

There is little in the legislative deliberations during 1958,[58] the year in which subchapter S was enacted, to indicate the reason for the one class of stock requirement. However, the predecessor provisions of subchapter S under which small corporations would have been taxed as partnerships, were considered by the Senate in 1954.[59] The proposed legislation included a requirement that in order to be eligible a corporation could have only one class of stock. The purpose of this requirement was to avoid the administrative complexities which would arise in the allocation of earnings and losses among several classes of stock, and in particular in allocating when there is a payment of

[57] *Id.* at 2333.
[58] S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958) .
[59] S. REP. No. 1622, 83d Cong., 2d Sess. 119, 453-54 (1954).

dividends on preferred stock in excess of earnings.[60] Under this theory, then, the one class of stock requirement is compatible with the overall purpose of the subchapter S provisions, which is to make tax relief available to small corporations essentially comparable to partnerships and proprietorships.[61]

The problem of allocating earnings and losses does not appear to be significant in the case of shareholder debt. The rights of the debtor are specified in the instrument. Thus, there is not the problem as there is when preferred stock is present—discretionary action by the board of directors in declaring dividends. Section 1376 provides for the situation where losses exceed the basis of the common stock and the common stockholders have debt, by permitting the recovery of the debt after the entire basis in stock has been consumed.[62] This appears to be the position of the courts in the cases discussed *supra*, beginning with the Tax Court's opinion in *Gamman*.[63]

The Tax Court's rejection of both of the regulations which have been promulgated under section 1371(a)(4) raises the important question of what authority the court will give to any regulation pertaining to shareholder debt and the one class of stock requirement. One of the concurring opinions[64] in the *Stinnett* case would seem to indicate that any authority given to such a regulation will be light because no authority to promulgate legislation was given to the Commissioner under subchapter S, whereas section 1244 which was enacted along with subchapter S to aid small businesses did contain such authority. It was also noted that

> . . . section 415 of the recently enacted Tax Reform Act of 1969 . . . provides legislative authority to [the Commissioner] to determine whether 'an interest in a corporation is to be treated for purposes of *this title* as stock or indebtedness.' This extremely broad grant still leaves open the question whether it includes authority to prescribe what is a *second class* of stock for purposes of Subchapter S.[65]

Any regulation which is promulgated under section 1371(a)(4), then, should be consistent with the language of that section, which, after all, refers to stock and not to equity capital. The prior regulations have attempted to subject a corporation's subchapter S status to

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[60] *Id.* at 453.

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

[62] *See generally* McGaffey, *The Requirement that a Subchapter S Corporation May Have Only One Class of Stock*, 50 MARQ. L. REV. 365, 373-75 (1966).

[63] W. C. Gamman, 46 T.C. 1 (1966).

[64] James L. Stinnett, Jr., CCH TAX CT. REP. 2327, 2334-35 (Dec. 29, 995, 54 T.C.—, No. 20, Feb. 11, 1970).

[65] *Id.*

the debt-equity test developed in the conventional corporation situation. This test "is merely a tool for reasoning"[66] and should not be considered conclusive of the question of whether a corporation electing under subchapter S has more than one class of stock. In the final analysis the test for this issue should be to determine "whether the instrument has sufficient characteristics under the applicable local law to be designated as"[67] a class of stock. Such a test would be reasonable and consistent with the statute and its underlying purpose.

David L. Fister

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[66] *Id.* at 2335.
[67] *Id.* at 2334.