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Subchapter S and the One Class of Stock Requirement

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The court in *Grillo* found the limitation of the multiple listing service to a restricted membership to be an unreasonable restraint. But it did not distinguish between membership restrictions and the refusal by the Board to furnish multiple listing information to non-members. By ordering multiple listing information to be made available to all real estate brokers for the asking, *Grillo* did what *Associated Press* specifically refused to do. Undoubtedly the initial fee and waiting period were unreasonable,⁴⁵ but the court might have examined the specific circumstances surrounding the actual denial of membership to the plaintiff. An examination of the refusal to furnish information might then have been made absent the objectionable membership restrictions. However, the court apparently was not prepared to consider these factors. It characterized the business of real estate brokers as subject to a "specific public interest"⁴⁶ and preempted from private restraints by a "comprehensive scheme of public regulation,"⁴⁷ concluding that there was no legitimate basis for refusing membership. It is questionable whether standards imposed by statute for obtaining and retaining a professional license sufficiently promote the advancement of professional standards and protect the public in its real estate dealings.

Grillo suggests, at least, that a business association in a field with which the public is vitally concerned has an obligation to open its membership to all who seek to participate. But the interest which the public has in the conduct of real estate business is hardly any greater than that in many other commercial activities.⁴⁸ In this respect the decision presents grave implications for many local business associations organized to advance commercial standards and efficiency.

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SUBCHAPTER S AND THE ONE CLASS OF STOCK REQUIREMENT

Courts developed the thin corporation doctrine to deal with the problem presented when invested capital was "dressed-up" to appear to be a loan, with consequent income tax advantages both to the corpor-

⁴⁵"There can be no proper justification for a large participation fee to be paid by a new board member to become a participant in the Multiple Listing activity. Any initial charge should be related to the actual cost of starting the services to him." Dep't of Bd. Services, *supra* note 1, at 10.

⁴⁶219 A.2d at 643.

⁴⁷*Id.* at 648.

⁴⁸The court itself intimated as much. *Id.* at 643.

ate-borrower and to the stockholder-lender.¹ When invested capital is disguised as a loan, the thin corporation doctrine is applied to pierce the disguise and reveal the true character of the transaction. Nomenclature is disregarded and a purported corporate debt is treated as invested capital.² The corporation is then deprived of the attendant tax advantages, and amounts paid as interest on the purported debt are treated as capital distributions, for which, unlike interest payments, the corporation is not permitted a deduction in calculating its taxable income.³ Amounts paid to stockholders as repayment of principal with respect to the so-called debt are treated as dividends on stock, taxable to the stockholder rather than as a nontaxable return of capital.⁴

Soon after Congress enacted Subchapter S of the Internal Revenue Code of 1954,⁵ which allows a small business corporation to elect to be taxed as a partnership or as a proprietorship,⁶ it was suggested that the thin corporation doctrine might be applied to defeat the

¹Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1, 9 (1965); Stinson, *Terminating the Election Under Subchapter S*, N.Y.U. 18TH INSTIT. ON FED. TAX 707, 721 (1960).

There are two basic reasons for thinly incorporating. Frequently the only way by which a closely held corporation can secure adequate financing is by loans from shareholders. There are also tax advantages. With respect to capital furnished by loans, the tax advantages are threefold. First, the periodic payments to the lenders for making the loans are deductible by the corporation as interest payments; second, repayment of the advances is tax free; and third, the loss sustained when the corporation fails is deductible as an ordinary loss in the case of a business bad debt or as a short term capital loss if the loss is not a business bad debt. Kahn, *How To Plan a Safely Thin Corporation in Face of Today's Obstacles*, 8 J. TAXATION 341 (1958). The thin corporation doctrine was promulgated to prevent corporations from disguising capital advances as debts and thereby receiving these tax advantages. 24 J. TAXATION 373, 374 (1966).

²See *O. H. Kruse Grain & Milling v. Commissioner*, 279 F.2d 123 (9th Cir. 1960), which is one of the leading thin corporation cases. The case sets out eleven factors to be considered.

³Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1, 9 (1965); Stinson, *Terminating the Election Under Subchapter S*, N.Y.U. 18TH INSTIT. ON FED. TAX 707, 721 (1960).

⁴Hrusoff, *Election, Operation and Termination of a Subchapter S Corporation*, 11 VILL. L. REV. 1, 9 (1965).

⁵INT. REV. CODE OF 1954 §§ 1371-77. The provision was suggested by President Eisenhower in his 1954 budget message to Congress and enacted in 1958. The complementary provision whereby a partnership could elect to be taxed as a corporation was enacted in the 1954 Code in §§ 1361. This latter provision has recently been repealed by P.L. 89-389.

⁶Louire, *Subchapter S After Six Years of Operation, an Analysis of Its Advantages and Defects*, 22 J. TAXATION 166, 167 (1965); Patty, *Qualification and Disqualification Under Subchapter S*, N.Y.U. 18TH INSTIT. ON FED. TAX 661, 662-63 (1960).

election.⁷ Before a corporation can elect to qualify under Subchapter S, it must meet certain requirements, relating mainly to the nature and number of shareholders:⁸ it must be a domestic corporation which is not a member of an affiliated group, have fewer than eleven shareholders, have only individuals or estates for shareholders, not have any nonresident alien shareholders, and have only one class of stock.⁹

The regulation with regard to the one class of stock requirement provides:

[O]nly stock which is issued and outstanding is considered. . . . 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 the voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. . . . *If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.*¹⁰

The suggestion that application of the thin corporation doctrine would

⁷See Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INSTT. ON FED. TAX 771, 819 (1959); Manley, *Election Under Subchapter S Can Eliminate Thin-Incorporation Problem*, 9 J. TAXATION 322, 323 n.2 (1958); Patty, *Qualification and Disqualification Under Subchapter S*, N.Y.U. 18TH INSTT. ON FED. TAX 661, 669-70 (1960); Roberts & Alpert, *Subchapter S: Semantic and Procedural Traps in Its Use; Analysis of Dangers*, 10 J. TAXATION 2, 4 (1959); Stinson, *Terminating the Election Under Subchapter S*, N.Y.U. 18TH INSTT. ON FED. TAX 707, 721 (1960).

See generally Kahn, *How To Plan a Safely Thin Corporation in Face of Today's Obstacles*, 8 J. TAXATION 341 (1958).

⁸Note, 19 TAX. L. REV. 391 (1964).

⁹INT. REV. CODE OF 1954, § 1371(a) 1-4. See INT. REV. CODE OF 1954, § 1504(a) for the definition of a member of an affiliated group.

¹⁰Treas. Reg. § 1.1371-1 (g) (1959), as amended, T.D. 6676, 1963. (Emphasis added.)

Since the writing of this comment, the Commissioner has changed § 1.1371-1 (g) of the Regulations by dropping the last sentence italicized in the text, and by adding the following: "Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock. 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 nominal stock or his 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." Treas. Reg. § 1.1371-1 (g) (1959), as amended T.D. 6904, 1967 Int. Rev. Bull. No. 5, at 13.

disqualify automatically an electing corporation was based on the last sentence of the above quoted regulation. The theory was that if the "debt" was in reality a contribution to capital under the thin corporation doctrine, the evidence of the "debt" would be a second class of stock and the corporation, now having more than one class of stock, would not qualify for the taxation treatment of a partnership.¹¹

However, the Tax Court in *W. C. Gamman*¹² recently refused to apply the thin corporation doctrine to a Subchapter S election. Gamman and Reese, the two stockholders involved,¹³ formed Century House, Inc. to build and operate a motel near the proposed site of the Seattle World Fair. Century House was thinly incorporated. Each of the stockholders paid \$200 to the corporation for capital stock and advanced over \$5,000 to the corporation in return for 6 per cent demand notes. At various times in the succeeding years the two stockholders made additional advances to the corporation because it had been unable to secure anticipated outside financial aid. These advances in excess of \$250,000 were evidenced by 6 per cent demand notes. At the time of trial no interest had been paid on the notes, nor had any effort been made by the stockholders to demand payment of the obligations. From time to time new notes were issued to replace the old ones to prevent the statute of limitations from barring collection.

The Commissioner disallowed deductions for losses incurred by Century House which Gamman and Reese had taken on their individual income tax returns on the ground that Century House did not qualify as a Subchapter S corporation. Consequently, the only question presented in *Gamman* was whether Century House met the one class of stock requirement and could qualify as a Subchapter S corporation.

In a six-to-five decision,¹⁴ the Tax Court held that Century House

¹¹Henderson v. United States, 245 F. Supp. 782 (N.D. Ala. 1965), did in fact reach this result.

¹²46 T.C. 1 (1966).

¹³There were three stockholders when Century House was formed but the corporation later bought the stock of the third stockholder and paid off his advances without interest. This third stockholder does not bear in the determination of this case so, for the purpose of simplicity, he has been left out of the discussion.

¹⁴The five dissenters said that there were two classes of stock since the notes in question were risk capital and not genuine indebtedness and since these instruments established different rights and preferences from those of the authorized stock. The dissenters argued that it was no answer to say that those different rights and preferences made no difference simply because they were not enforced nor because there was no evidence that the holders intended to enforce those rights later.

had only one class of stock for Subchapter S purposes, and so qualified as a Subchapter S corporation. The first step in the court's reasoning was to reject as invalid the last sentence of the regulation dealing with the one class of stock requirement:

[W]e find nothing in the law itself, the committee reports, or the assumed purpose of the legislation that would justify holding, arbitrarily and per se, that all instruments which purport to be debt obligations but which in fact represent equity capital, must be treated as a second class of stock for purposes of section 1371. Consequently we think the last sentence of the regulation . . . is too broad and places a restriction on the stockholders of the electing corporation which was not intended by Congress. . . . Where a regulation is an amendment or modification of the statute and therefore beyond the power of the Commissioner to make, courts must refrain from giving it effect.¹⁵

This led the court to a consideration of the facts. It concluded that the notes were evidence of capital contributions but were not a *second class* of stock because they did not give Gamman or Reese any rights or preferences different from those they already had as owners of the capital stock of the corporation. The following facts were mentioned as being determinative: The advances were made and the notes were held pro rata to the stockholdings; the right to periodic interest payments was waived; the right to demand payment of the notes was never exercised; the notes gave the stockholders no voice in the management of the corporation; and in case of bankruptcy it was highly likely that a court would have subordinated the claims of the noteholders to the other common creditors.

There are two earlier cases, *Henderson v. United States*¹⁶ and *Catalina Homes, Inc.*,¹⁷ which apply the thin corporation doctrine to defeat a Subchapter S election. The Tax Court distinguished those cases from *Gamman* on the ground that the last sentence of the regulation was not challenged in either case. While this is a distinction, it is doubtfully one on which the difference in result should be based.

Henderson simply held that the advances by the stockholders represented capital contributions and *a fortiori* a second class of stock under the last sentence of the controlling regulation.

Catalina, however, is distinguishable on its facts. There interest, like dividends, was payable only at the direction of the board of directors

¹⁵46 T.C. 1, 5-6 (1966).

¹⁶245 F. Supp. 782 (N.D. Ala. 1965).

¹⁷33 P-H Tax Ct. Mem. 1491 (1964).

and the advances were preferred over the no-par common stock. It is obvious that the notes were a second class of stock since the rights and preferences were not the same as those enjoyed by the no-par common stock. The fact that *Catalina* considered those factors represented a loosening, however slight, from the *a fortiori* approach taken by *Henderson*. *Gamman* took the reasoning one step farther and expressly repudiated the *a fortiori* approach. Just because an advance is deemed a capital contribution, it does not necessarily follow that the capital contribution results in a second class of stock. This point has since been recognized in *Lewis Bldg. & Supplies, Inc.*¹⁸

The *Gamman* holding is a step in the right direction. However, the Tax Court did not squarely meet a fundamental point: whether the thin corporation doctrine should have any applicability. The court said:

We also observe that while we have given lip service to the so-called thin capitalization doctrine we have some doubt as to its applicability in determining whether a corporation has more than one class of stock for purposes of Subchapter S.¹⁹

Properly analyzed, the doctrine has no applicability to a Subchapter S corporation. The tax advantages which normally accrue do not benefit a Subchapter S corporation since the corporate earnings pass directly to the shareholder.

A corporation remaining permanently in the tax option status would have no reason to desire a thin financial structure. Election of the tax option status allows a corporation to freely distribute its earnings without a tax effect. A corporate deduction for interest paid to a stockholder would be meaningless, and the accumulated earnings tax would not be applicable.²⁰

For this reason, application of the thin corporation doctrine itself to the Subchapter S corporation is meaningless. It only confuses two separate and unrelated problems.

Elimination of the application of the thin corporation doctrine to Subchapter S situations does not eliminate the necessity of determining whether a note evidencing the corporate indebtedness is a stock. Some of the factors considered in the thin corporation cases would still be

¹⁸¶ 66,159 P-H TAX CT. REP. & MEM. DEC. The case did not mention the invalidity of the regulation nor the correctness of using the thin corporation doctrine.

¹⁹46 T.C. 1, 8 (1966).

²⁰Garver, *Tax Factors Affecting Debt-Equity Financing for a New Small Corporation*, 17 W. Res. L. Rev. 773, 779 (1966).