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the transaction had been considered instead of its form. Either of the two methods would provide a more realistic view of the Hughes' type transaction and avoid a narrow and legalistic analysis of the statutory phrase "principal residence" which it appears that Congress never intended.

JAMES F. PASCAL

INVALID ELECTION AND INVOLUNTARY TERMINATION OF SUBCHAPTER S STATUS

Congress, in 1958, added Subchapter S¹ to the Internal Revenue Code in an attempt to allow "small business corporations"² to be taxed substantially as partnerships³ if the shareholders so elect.⁴ Before the special status can be used, however, the corporation must be a small business corporation as defined by the code⁵ and an initial, valid election must

¹INT. REV. CODE OF 1954, §§ 1371-79.

²A "small business corporation" is defined by INT. REV. CODE OF 1954, § 1371(a). Note 5 *infra*.

³There are differences between the taxation of a partnership and that of a Subchapter S corporation. Thus, as in the case of a regular corporation, redemption and liquidation are taxable events; the Subchapter S corporation has the same limitations on certain deductible amounts, such as charitable contributions, as does the regular corporation; the Subchapter S corporation's income retains its corporate character when distributed to shareholders, except for capital gains, and the nature of underlying assets, in general, does not determine the character of a gain. See Braverman, *Special Subchapter S Situations—Regulations Run Rampant*, 114 U. PA. L. REV. 680 (1966).

⁴A Senate committee report before the subchapter was enacted stated:

Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences.

S. REP. NO. 1983, 85th Cong., 2d Sess., 1958-3 CUM. BULL. 1008.

The following is an overview of the mechanics of Subchapter S. There is no tax at the corporate level (§ 1372(a)), but total taxable income of the corporation is taxed to the individual shareholders at personal income tax rates whether the income is actually distributed or not (§ 1373). Undistributed taxable income is not taxed again when it is later distributed. Capital gains of the corporation are passed to its shareholders, pro rata, at capital gains rates (§ 1375(a)), and corporate net operating losses are deductible by the individual shareholders on their personal returns (§ 1374(a)). Any losses deducted by the shareholders reduce the basis of their stock while corporate income not distributed to them increases their basis (§ 1376).

⁵INT. REV. CODE OF 1954, § 1371(a) provides:

(a) Small business corporation.

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—

have been made.⁶ Although advantageous in many respects,⁷ a Subchapter S election can also prove disastrous. This is seen most readily when Subchapter S status is involuntarily terminated or found to have been void *ab initio*. The disqualifying event is often unintentional and unknown to the corporation and its shareholders.⁸

Involuntary termination can come about in a variety of ways. The corporation may take some action which causes it not to be a "small business corporation" as defined in the code.⁹ Also, if eighty percent or more of the corporation's income is from foreign sources,¹⁰ twenty per-

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- (1) have more than 10 shareholders;
 - (2) have as a shareholder a person (other than an estate) who is not an individual;
 - (3) have a nonresident alien as a shareholder; and
 - (4) have more than one class of stock.

⁶INT. REV. CODE OF 1954, § 1372(a). Form 2553 and a statement of consent by each shareholder are filed with the Internal Revenue Service. Treas. Reg. § 1.1372-2(a) (1959). Thereafter, instead of filing a regular corporate income tax return (Form 1120), the corporation files an information return (Form 1120-S).

Once the election is validly made, it need not be renewed for subsequent years (§ 1372(d)). Election can be voluntarily revoked if all shareholders consent (§ 1372(e)(2)), but the election cannot be revoked for the first taxable year in which it is effective. Also, the revocation must be made within the first month of a taxable year to make it effective for that taxable year. Treas. Reg. § 1.1372-4(c) (1959). If made after the first month, the revocation will be effective for the subsequent taxable year and years following.

⁷Some advantages are: limited liability with no double tax; the tax on unreasonable accumulations does not apply; the taxpayer receives an ordinary income deduction for corporate operating losses; and, certain benefits are made available to corporate employees and are deductible by the corporation such as profit-sharing, qualified pension plans, group life insurance and tax exempt death benefits without the corporation itself paying a tax. Moreover, a Senate Committee reported:

Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business. It will be primarily beneficial to those individuals who have marginal tax rates below the [48-percent] corporate rate (or [22 percent] rate in the case of the smaller corporations) where the earnings are left in the business. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates since in this case a "double" tax is removed. The provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses.

S. REP. NO. 1983, 85th Cong., 2d Sess., 1958-3 CUM. BULL. 1008.

⁸See, e.g., Milton T. Raynor, 50 T.C. 762 (1968).

⁹Note 5 *supra*.

¹⁰INT. REV. CODE OF 1954, § 1372(e)(4).

cent or more is "passive investment income",¹¹ or if a new shareholder fails to make the election,¹² the corporation loses its Subchapter S status. The special status terminates automatically when any of these things happen, and the termination is retroactive. This means that all open years back to the year in which the disqualifying event took place can be analyzed by the Internal Revenue Service in assessing possible deficiencies,¹³ which in many situations places extreme financial hardships on the shareholders and their corporation, especially where the prohibited event goes undetected for years.¹⁴ Thus, shareholders must be extremely careful in electing and keeping their Subchapter S status. This being the case, whether Subchapter S is accomplishing its purpose of allowing businesses "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences"¹⁵ is debatable.¹⁶

Courts within the Fourth Judicial Circuit of the United States have

¹¹INT. REV. CODE OF 1954, § 1372(e)(5). Passive investment income "means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities" INT. REV. CODE OF 1954, § 1372(e)(5)(C).

¹²INT. REV. CODE OF 1954, § 1372(e)(1).

¹³INT. REV. CODE OF 1954, § 1372(e).

¹⁴Thus, the corporation will owe a corporate tax for the year in which the disqualifying event took place and for all subsequent open years in which it had relied on its election (§ 1372(e)(3)), even though shareholders have already paid a tax on the income. If the income is distributed, it will not benefit the individual to file an amended return. Undistributed taxable income, the tax on which has already been paid, cannot be later distributed without the shareholders incurring taxes, at least at capital gains rates (Treas. Reg. § 1.1375-4(a) (1959)). Deficiencies will be assessed against the shareholders where they have deducted net operating losses of the corporation on their returns. *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965). After either a voluntary or involuntary termination, the corporation cannot again elect Subchapter S status for five years (§ 1372(f)). *But see*, Treas. Reg. § 1.1372-5 (1959).

¹⁵Note 4 *supra*.

¹⁶One author has stated:

Moreover, far from simplifying the tax treatment of small business corporations, the legislative provisions, the regulations and the court decisions have grafted upon the Congressional intent a myriad of highly technical, complex and sometimes artificial requirements, the inadvertent transgression of which can call down horrendous tax consequences upon the heads of the unsuspecting and unwitting shareholders.

Ekman, *Subchapter S: Problems of Elections and Terminations*, N.Y.U. 28TH INST. ON FED. TAX. 475, 475-76 (1970).

Another has said:

Perhaps the greatest deterrent in electing under Subchapter S is the possibility of accidental or involuntary termination of the election and a subsequent incurrence of double taxation.

Swietlik, *Subchapter S: What Is It and How Does It Work*, 44 MARQ. L. REV. 470, 492 (1961).

decided several cases concerning different situations where it was argued that Subchapter S elections had been involuntarily terminated. Prerequisites for valid election which have been in question include the "one class of stock requirement",¹⁷ the prohibition of trusts as shareholders¹⁸ and the affiliated group prohibition.¹⁹

THE ONE CLASS OF STOCK REQUIREMENT AND VOTING RIGHTS

A corporation's Subchapter S status will be terminated if, at the time of election or subsequent thereto, it had outstanding more than one class of stock.²⁰ Problems under this requirement may arise in many ways,²¹ but the situation to be discussed here concerns only one facet, that of a distinction in voting rights. The regulations clearly state that any difference in voting rights among the shares will disqualify the corporation.²²

¹⁷INT. REV. CODE OF 1954, § 1371(a)(4).

¹⁸INT. REV. CODE OF 1954, § 1371(a)(2).

¹⁹INT. REV. CODE OF 1954, § 1371(a).

The Fourth Circuit has also decided a case concerning the timely election requirement (§ 1372(e)), but since that case concerned only the question of who had the burden of persuasion to show timely election, it is not included here. Frank E. Poulter, P-H Tax Ct. Mem. ¶ 67,220 (1967), *aff'd*, 397 F.2d 415 (4th Cir. 1968).

²⁰INT. REV. CODE OF 1954, § 1371(a)(4); Treas. Reg. § 1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219.

²¹Indeed, the Tax Court decision in *W.C. Gamman*, 46 T.C. 1 (1966) led to a rewriting of Treas. Reg. § 1.1371-1(g). The most common problem is that where the stockholders make advances to the corporation calling them "debt." Often, however, no instrument evidences the debt; there is no maturity date; no interest is stated; no payment is demanded; principal is paid only if the business shows a profit; and the corporation's capital structure is thin. The general rule since *Gamman* is that even if these advances constitute equity, they will not be a second class of stock unless the advances are made disproportionately to actual stock holdings. The original regulation stated, "[i]f an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock." The corresponding portion of the amended regulation provides:

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), T.D. 6904, 1967-1 CUM. BULL. 220. For cases involving the debt-equity argument, see *Brennan v. O'Donnell*, 426 F.2d 218 (5th Cir. 1970); *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965); *James L. Stinnett, Jr.*, 54 T.C. 221 (1970); *Milton T. Raynor*, 50 T.C. 762 (1968); *Lewis Building & Supply Co.*, P-H Tax Ct. Mem. ¶ 66,159 (1966).

²²Treas. Reg. § 1.1371-1(g) (1967) provides in part:

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

The case within the Fourth Circuit to deal with this problem was *Barnes Motor & Parts Co. v. United States*.²³ There, voting common was issued when the corporation was organized in 1925, but nonvoting shares were issued in 1941. The taxpayer claimed that all the latter shares had been treated as voting shares since 1944, and further, that the last shares of non-voting stock were cancelled in 1964 by the issuance of voting shares in their place. A Subchapter S election was made in 1958, and deficiencies were assessed for the open years, 1963 through 1966. The taxpayer contended that the election was valid because when it was made all shares were voting.

The court, after noting that the purpose of the one class of stock requirement was to make allocation of undistributed income easier,²⁴ found for the Commissioner on the ground that the last shares of non-voting stock were not cancelled on the corporation's books until a 1967 reorganization. Therefore, the court noted, a second class of stock did exist when the election was made.²⁵

Although a class of stock labeled non-voting had been issued, the court implied that if the taxpayer could have proven that the shares actually had been voting, it might have won the case. However, every corporate decision had been unanimous, so it was impossible to say how many shares voted. Thus, the court held that to assume the non-voting shares had voted would be mere speculation.²⁶

Obviously, these shares may have been voting, in which case, if substance were recognized over form, the election might have been valid. It simply was impossible for the taxpayer to prove the fact upon which its case rested, and this caused the corporation a severe financial setback.²⁷ Although the court correctly applied the regulations,²⁸ the question may be asked whether the regulations are justified in light of statutory policy.

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.

²³309 F. Supp. 298 (E.D.N.C. 1970).

²⁴The court stated:

This requirement was inserted in the statute because holders of preferred stock have certain preferences in distribution rights over holders of common stock, voting stock is worth more than non-voting stock and the government, if forced to account for these value differences, would have a difficult time in allocating the proper proportion of earnings or losses to each individual shareholder.

Id. at 301.

²⁵The taxpayer admitted the stock was outstanding (although voting) until 1964. *Id.* at 302. Hence, whether they were cancelled in 1964 or 1967 makes little difference.

²⁶*Id.* at 303.

²⁷The deficiency was over \$104,000. *Id.* at 301.

²⁸Treas. Reg. § 1.1371-1(g) (1967). Note 22 *supra*.

It would seem that the statutory requirement of one class of stock is necessary when the classes have different distribution rights but that the regulations go too far in providing that the corporation will be disqualified for issuing stock with different voting rights. If the stock has different distribution rights as do, for example, common and preferred, the government is going to be put to the task of allocating undistributed taxable income to shareholders where taxed distribution per share is not equal. However, when all stock participates equally in distributions and the only difference in the stock is voting rights, there would seem to be no such problem.

The court in *Barnes Motor* stated that voting stock is worth more than non-voting stock, and this caused allocation problems as do different distribution rights.²⁹ This, however, does not appear to follow. As far as the allocation of undistributed taxable income is concerned, the worth or market value of the stock would seem irrelevant. If the distribution rights are equal and thus every share receives the same amount upon any type of corporate distribution, no difficulty arises in allocating income to the shareholders since they are charged, pro rata, with that amount they would have received had all income been distributed.

The same reasoning would seem to apply where there is a voting agreement among shareholders all of whom hold voting shares³⁰ or where stock has different weights in electing the board of directors. The latter situation was presented in *Pollack v. Commissioner*³¹ where there were four groups of stock of unequal size and each group elected one director. The court held that since the voting rights were disproportionate, more than one class of stock had been created, and a Subchapter S election was invalid.³²

The validity of an election where there was a voting agreement was in question in *A & N Furniture & Appliance Co. v. United States*³³ where a voting trust consisting of all shares had been established. The Commissioner claimed this created a new class of stock, arguing that although a second class was not created in form, it was in substance, since all voting power vested in the trustee while the shareholders themselves were left with none. The court, however, said that the shareholders re-

²⁹Note 24 *supra*.

³⁰This was the situation presented in *A & N Furniture & Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967) discussed in text accompanying note 33 *infra*.

³¹47 T.C. 92 (1966), *aff'd*, 392 F.2d 409 (5th Cir. 1968).

³²392 F.2d at 411. The validity of the regulation was questioned in *Catalina Homes, Inc.*, P-H Tax Ct. Mem. ¶ 64,225 (1964), but since the case could be disposed of on other grounds, the question was not decided.

³³271 F. Supp. 40 (S.D. Ohio 1967).

tained all beneficial interests in their shares except the right to vote³⁴ and that this would cause no allocation problems. The government then argued that a regulation³⁵ stated that voting agreements would give rise to a second class of stock, but the court said that this provision was meant to apply when two classes had been issued and not when shares with equal rights were placed in a voting trust. The government next contended that this situation was no different than one in which shareholders had given an irrevocable proxy to another, and the Commissioner had specifically held by revenue ruling³⁶ that irrevocable proxies would disqualify the corporation. The court agreed that the situations were essentially the same, but held the ruling invalid as an erroneous interpretation of the code.³⁷

The *A & N* decision seems justified, although contrary to the government's clearly stated regulation; it will be interesting to see if the reasoning and decision in that case are followed. However, it seems that the court did not go far enough since it indicated that if all the shares had not been in the voting trust, the result would have been different. The

³⁴The court stated: "The shareholders are still entitled to the same proportionate benefits from the corporation as they were before the creation of the voting trust." 271 F. Supp. at 44.

³⁵Treas. Reg. § 1.1371-1(g) (1967) quoted in note 22 *supra*.

³⁶Rev. Rul. 63-226, 1963-2 CUM. BULL. 341 states in part:

Because of the restrictions placed upon the inactive shareholders under the agreement in the instant case [involving an irrevocable proxy], 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 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.

It is noted in Crumbley & Davis, *Tax Planning for Shareholders of Subchapter S Corporations*, 26 TAX L. REV. 643 (1971) that the ruling, if valid, means that not all shareholders would have to enter the irrevocable proxy agreement to disqualify the corporation. Thus, by implication, if only one holder gives an irrevocable proxy, the corporation would be disqualified. This could lead to minority rule in the corporation. In any event, for safety, any proxy should be revocable. This would not seem to disqualify the corporation. Under the applicable statute and regulations, it is nebulous why an irrevocable proxy would disqualify and a revocable one would not. For instance, under the government's theory, would a revocable voting trust disqualify the corporation? If so, what is the difference between this and a revocable proxy?

³⁷271 F. Supp. at 45.

theory upon which this dictum was based was that since voting stock is worth more on the market than non-voting shares, the government would be put to the effort of allocating income. Again, however, it is submitted that the market value of the stock is not important in the matter of allocation. It is distribution rights which should be equal for allocative ease, since this will result in the equal division of income among the shares. A voting trust of less than all the shares leads to no allocation difficulties. Thus, the same arguments apply here as were stated in relation to *Barnes Motor*,³⁸ although a minor difference seems to be that in the voting agreement cases only the interpretation of the statute needs change, while the statute³⁹ itself may have to be amended where both voting and nonvoting stock have been issued.

THE PROBLEM OF TRUSTS AS SHAREHOLDERS

The government contends that voting trusts not only violate the one class of stock requirement but also the prohibition of trusts as shareholders. The code⁴⁰ and the regulations⁴¹ disqualify a corporation from Subchapter S status if a trust holds any shares. One reason for the prohibition of trusts as shareholders seems to be that if the trust has more than one beneficiary, there may be, in effect, more than ten "shareholders."⁴² Secondly, practicalities require that shareholders of a Subchapter S corporation be entities whose tax status can be readily determined for ease in administration.⁴³ However, if the settlors are the beneficiaries and the income is taxed to them,⁴⁴ these problems are reduced. Further, the requirement may be a vestige of the "active management rule" which states that shareholders given the Subchapter S election should be actively engaged in carrying on the business.⁴⁵

The Fourth Circuit has ruled on two cases involving regular trusts, as distinguished from voting trusts and found violations of the prohibition of trusts as shareholders. The first, *Old Virginia Brick Co. v. Commissioner*,⁴⁶ presented an interesting and somewhat unusual fact situation. Here, a testator died in 1941, leaving a large block of stock to his wife for life with remainder to his children. The stock was to be held in

³⁸Text accompanying note 23 *supra*.

³⁹INT. REV. CODE OF 1954, § 1371(a)(4).

⁴⁰INT. REV. CODE OF 1954, § 1371(a)(2).

⁴¹Treas. Reg. § 1.1371-1(e) (1959).

⁴²This would violate the purpose of section 1371(a)(1).

⁴³Landon, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 805 (1971).

⁴⁴INT. REV. CODE OF 1954, § 671-78.

⁴⁵Braverman, *supra* note 3.

⁴⁶44 T.C. 724 (1965), *aff'd*, 367 F.2d 276 (4th Cir. 1966).

trust if and when a probate court ordered the estate to be closed. All duties of administration were completed in 1946, but the estate was not closed by the probate court until the wife's subsequent death in 1963 after she, as executrix, had consented to a Subchapter S election in 1959. The probate court had never required a final settlement of the husband's estate between 1941 and 1963. The Commissioner concluded that a testamentary trust had come into effect in 1946 when all duties of administration were completed and assessed a deficiency in the corporation's taxes. The taxpayer argued that no trust was created since under Virginia law if a life tenant is given unrestricted power to invade corpus for her own benefit, she is deemed to be personally possessed of the corpus.⁴⁷

Of course, if the 1959 election had been by an estate rather than a trust, it would be valid.⁴⁸ The court, however, determined that for tax purposes an estate terminates once necessary administrative duties are completed, whether or not the executor has assumed the role of trustee pursuant to court order.⁴⁹ In *Old Virginia Brick*, the court noted, these duties were completed far before the election. Further, the court accepted the government's contention that when administration was complete a trust sprang up, and held that the widow's power to invade was not so unfettered so as to result in there being no trust.

Although the decision seems correct under the applicable code and regulation sections, this corporation was prevented from making the election, at least until the widow died and the stock was distributed outright. The testator unknowingly⁵⁰ had made it impossible for the shareholders to elect Subchapter S status, since even if the estate had been closed when actual administrative duties were concluded, a trust would have arisen. Such a result seems harsh when it is realized that had Subchapter S been in effect when the testator made his will, he could have easily disposed of his stock in such a manner that an election would not have been precluded.⁵¹ Thus, it seems somewhat inequitable to deny this corporation an option given to similar corporations purely for action taken by the testator prior to the enactment of Subchapter S in 1958.

⁴⁷For this proposition, the taxpayer cited *Gardner v. Worrell*, 201 Va. 355, 111 S.E.2d 285 (1959).

⁴⁸INT. REV. CODE OF 1954, § 1371(a)(2).

⁴⁹Treas. Reg. § 1.1371-1(e) (1959) provides that a trust includes all trusts subject to subchapters D, F, H, or J. Treas. Reg. § 1.641(b)-3(a) (1956) under Subchapter J provides that a trust arises when administrative duties are completed.

⁵⁰The Subchapter S option was passed by Congress seventeen years after the testator's death.

⁵¹Thus, the stock could have been held in joint ownership, specifically bequeathed outright, specifically bequeathed subject to a life estate, or the stock could have been made the subject matter of a buy-sell agreement. See generally Crumbley & Davis, *Tax Planning for Shareholders of Subchapter S Corporations*, 26 TAX.L. REV. 643 (1971).

The same type of problem, that of a corporation being "locked out" of Subchapter S treatment, arose in the Fourth Circuit decision of *Fulk & Needham, Inc. v. United States*.⁵² A member of a partnership had died in 1954, and his estate, a large part of which was his interest in the business, passed into trust to his wife for life, remainder to his children. The wife and children were co-executors and would become co-trustees. In 1955 the partnership incorporated, and stock was transferred to the Fulk estate. The estate was closed the following year, and a Subchapter S election was subsequently made. This was obviously, in form, a testamentary trust but the widow argued that the trust should be disregarded because she had treated the shares as belonging to her.⁵³ She had reported both distributed and undistributed income in her return, and no fiduciary return had been filed; she alone served as spokesman for the Fulk interests. The court rejected her argument and found the election invalid, holding that none of these actions were inconsistent with there being a trust.⁵⁴

As in *Old Virginia Brick*,⁵⁵ this corporation had no chance to become a Subchapter S corporation until the wife died. If the primary purpose of the no trust requirement is to provide for administrative ease, the result in *Fulk* would seem of tenuous validity since returns were regularly filed by the wife reporting both distributed and undistributed income. Although the problem of a corporation being locked out of Subchapter S because of a testator's action prior to enactment of the statute in 1958 will lessen in the future,⁵⁶ it would seem that some relief should be given to corporations which find themselves in this situation. Because cases such as this would appear to be relatively rare, the election could be allowed and allocation made on a case by case approach. The shareholders, obviously, would have the burden of persuasion to show that they, through no action or fault of their own, were unable to make the election.

The fact that ordinary trusts are excluded as shareholders in the Subchapter S corporation is both logical and necessary.⁵⁷ The election was added to benefit small businesses, although no limits were put on the amounts of capital or assets. Using the trust device could lead to easy

⁵²411 F.2d 1403 (4th Cir. 1969), *aff'g* 288 F. Supp. 39 (M.D.N.C. 1968).

⁵³However, it would seem that if the trust were disregarded, the terms of the will which set up the trust would be violated.

⁵⁴411 F.2d at 1407.

⁵⁵Note 46 and accompanying text *supra*.

⁵⁶As years go by, fewer and fewer testators will have died before Subchapter S went into effect.

⁵⁷This is true where the ordinary trust is not one in which trust income is taxed to the settlor rather than to the trust itself or the beneficiaries other than settlors. INT. REV. CODE OF 1954, §§ 671-78. The "settlor trust" presents a situation analogous to the voting trust.

circumvention, in substance, of the ten shareholder requirement, thus nullifying the one requirement upon size of the corporation. Further, unless the trust were one in which income was definitely taxed to the settlor, complications could arise concerning to whom undistributed taxable income should be taxed. Therefore, it would seem best to keep the no trust requirement but modify the regulations for flexibility where, for example, the corporation is "locked out" of the election.

Voting trusts have caused difficulties under the no trusts as shareholders requirement as they have under the one class of stock requirement. Although the Fourth Circuit has not decided any cases where it was claimed that a voting trust had been established thus violating the prohibition of trusts as shareholders under section 1371(a)(2), voting trusts, as distinguished from the traditional private trusts discussed above, present a clear situation where administrative difficulties would not seem to exist and the election should be allowed. Yet the regulations⁵⁸ explicitly state the fact that where stock is held by a voting trust, no election can be made. This regulation is not based on a violation of the one class of stock requirement but was put forth under section 1371(a)(2) which states that only individuals or estates can be shareholders of Subchapter S corporations. The regulation has not gone uncriticized, however, for in *Catalina Homes, Inc.*⁵⁹ the government contended that the voting trust violated the prohibition of trusts as shareholders. The Tax Court questioned the validity of the regulation, indicating that it was not sure the measure represented a reasonable interpretation of the statute and the intent of Congress.⁶⁰ The regulation⁶¹ was subsequently held invalid in *A & N Furniture & Appliance Co. v. United States*⁶² where, as noted earlier,⁶³ the court also stated that a voting trust did not violate the one class of stock requirement. To the contention that the voting trust violated the prohibition of trusts as shareholders, the court said that it could not conceive of any reason why a voting trust should even be considered a shareholder.⁶⁴

The *A & N* decision on this question seems logically correct. In the voting trust situation, income is taxed to the settlor, and it would seem that no allocation problems should arise. It will probably be true, however, that any time the shareholders of a Subchapter S corporation do create a voting trust, litigation will arise since the government will con-

⁵⁸Treas. Reg. § 1.1371-1(e) (1959). See also Rev. Rul. 226, 1963-2 CUM. BULL. 341.

⁵⁹P-H Tax Ct. Mem. ¶ 64,225 (1964).

⁶⁰Note 4 *supra*.

⁶¹Treas. Reg. § 1.1371-1(e) (1959).

⁶²271 F. Supp. 40 (S.D. Ohio 1967).

⁶³Text accompanying notes 33-36 *supra*.

⁶⁴271 F. Supp. at 46.

tend that the stock is not held by an individual or estate as section 1371(a)(2) requires. It would seem that the voting trust, for purposes of election under Subchapter S, should be treated separately from other trusts, and it is suggested that the regulations be amended to so provide.

THE AFFILIATED GROUP PROHIBITION

A further means by which a corporation may lose its Subchapter S status is by becoming a member of an affiliated group, in which case it would no longer be a "small business corporation."⁶⁵ The affiliated group prohibition seems to have caused few problems, and cases are rare.⁶⁶ This was, however, an additional problem raised in the *Barnes Motor* case.⁶⁷ Here, a Subchapter S election was made in 1958 after the corporation had created a subsidiary in 1955. The taxpayer corporation owned all stock in the subsidiary until 1961 when sixty percent was transferred to shareholders of the parent, thus terminating the affiliation.⁶⁸ The corporation created another subsidiary in 1964 and kept 350 shares while the subsidiary's manager owned the remaining 100.⁶⁹ This subsidiary was liquidated in 1965, and deficiencies were assessed for 1963 through 1966. The taxpayer claimed that since the prohibited affiliation was terminated

⁶⁵INT. REV. CODE OF 1954, § 1371(a), quoted in note 5 *supra*, defines a "small business corporation." The corporation must not be a member of an affiliated group as defined by section 1504(a) which provides as follows:

(a) Definition of "affiliated group."

As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

- (1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and
- (2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

⁶⁶For another case dealing with the affiliated group prohibition in a Subchapter S setting, see *Coca-Cola Bottling Co. v. United States*, 443 F.2d 1253 (10th Cir. 1971).

⁶⁷Text accompanying note 23 *supra*.

⁶⁸*Barnes Motor & Parts Co. v. United States*, 309 F. Supp. 298, 303 (E.D.N.C. 1970). The affiliation would cease after the transfer of stock to shareholders because less than 80% would be owned by the parent.

⁶⁹*Id.* at 300. Thus, this would be a prohibited affiliation as the parent owned 87.5 percent of the subsidiary. Note 65 *supra*.

with the first subsidiary before the years in question, the government should not be allowed to question the returns nine years after the election and six years after the disqualifying event was ended. The court easily disposed of this contention by pointing out that since the election was invalid when made, it would not be valid for subsequent years, and held further that the second subsidiary was also a disqualifying violation.⁷⁰

There seem to be two reasons for the prohibition of affiliated groups. First, the Subchapter S election was meant for relatively small, uncomplicated businesses, not those with more complex capital structures and tax problems. It purports to allow the proprietorship or partnership to have advantages such as limited liability without worry over tax consequences. The prohibition, therefore, would seem to help limit the size of the total business organization. Second, allocation of income could be extremely difficult when the affiliated group chose Subchapter S taxation, at least where the subsidiary was not completely owned by the parent. For example, where there are minority shareholders of the subsidiary, it would have to be determined with how much of the group's income they would be charged. Furthermore, more shareholder consents would be necessary in order to elect Subchapter S status, and it is not clear who would be required to file these. If individual shareholders of the subsidiary were not required to file, a loophole in the number of shareholders requirement would be opened. The allocation becomes less difficult, however, when the subsidiary is wholly owned, and it has been suggested that section 1371(d) be amended to provide that in this situation, the group would qualify for the election.⁷¹ This would not appear to be the best proposal for it would seem to defeat one of the underlying bases of the Subchapter S election which is to give relatively small businesses many advantages of the corporate form without attendant tax disadvantages. Allowing affiliated groups to elect Subchapter S would cater to larger and more complex organizations whose operations resemble those of the traditional corporation rather than those of a small partnership or proprietorship. Further, the effects of prohibition can be circumvented somewhat even now by distributing the stock of what would be a subsidiary within the family or group of persons holding the parent's stock.⁷²

It is obvious that Subchapter S can provide the small business with

⁷⁰If taxpayer's contention had been upheld the deficiency, because of the violation by the second subsidiary, would be only for 1964 through 1966 instead of 1963 through 1966. This would have saved taxpayer \$24,987.69 out of a total deficiency assessment of \$104,651.91. *Id.* at 301.

⁷¹*See, e.g.,* Landon, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 804 (1971).

⁷²In other words, two distinct corporations would be established, and both would, through the common shareholders, elect Subchapter S status.