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SUBCHAPTER S AND ITS EFFECT ON THE CAPITALIZATION OF CORPORATIONS

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Our federal tax laws encourage the creation of complex capital structures. "Thinning" capitalizations by issuing corporate indebtedness offers well known tax advantages to both shareholder and corporation.[1] Also, since 1954, issuing preferred stock on incorporation is a standard procedure for side-stepping the "bail-out" prohibitions of code section 306. A "good" capitalization from a tax viewpoint, therefore, will often involve a small base of common stock, a heavier layer of preferred stock and as much debt as the tax adviser believes will be given tax recognition.

A counterforce to this is contained in the tax legislation enacted September 2, 1958—the Technical Amendments Act of 1958 and Small Business Tax Revision Act of 1958.[2] The former adds to the code new Subchapter S, which permits a "small business corporation" to elect not to be taxed.[3] The latter creates new section 1244, which allows individuals or partnerships an ordinary deduction for losses on "small business corporation" common stock issued to them under a specific plan. No coordination exists between these two provisions, as is indicated by their conflicting eligibility rules and completely different definitions of "small business corporation." Under section 1244 the definition need be met only when the plan to issue stock is adopted, while under Subchapter S failure to meet the definition at any time will automatically terminate the election.

I. Risky Ventures

Today, if a venture is risky, a simple capital structure of common stock only may be the best tax choice, for it will usually be desirable to qualify all or part of the investment under code section

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1. See Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX 771 (1959), reprinted in 43 MARQ. L. REV. 31 (1959).

2. See generally Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COL. L. REV. 1146 (1958); Moore and Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453 (1959).

3. Effective September 24, 1959, Subchapter S was amended in three important respects: (a) husband and wife are treated as one shareholder for the 10-or-less shareholders requirement if they hold stock as community property, joint tenants, tenants by the entirety, or tenants in common; (b) a deceased shareholder may deduct his pro rata share of the *S* corporation's net operating loss though he dies before the end of the corporation's taxable year; and (c) the *S* election is automatically terminated if the corporation becomes a member of an "affiliated group," whether or not a consolidated income tax return is filed. See Pub. L. No. 86-376 § 2, 73 Stat. 699 (1959) (U.S. CODE CONG. & AD. NEWS 4240 (Oct. 20, 1959)).

1244.[4] Consideration will have to be given to both the $500,000 ceiling on the amount of stock to be offered under such plan,[5] and the annual maximums for the allowable ordinary loss treatment—$25,000 for an individual return, $50,000 for husband and wife filing a joint return. And consideration will then have to be given to the $1,000,000 overall limit on the corporation's "equity capital," defined as "the sum of its money and other property . . . less the amount of its indebtedness *(other than indebtedness to shareholders)*."[6]

But nothing in section 1244 prevents use of corporate debt, preferred stock or any other classes of stock. All it provides is that each year a limited ordinary loss deduction is available for an eligible corporation's "common stock," which may be voting or nonvoting, but not a security convertible into common stock nor common stock convertible into another security.[7] Other classes of stock are automatically relegated to their usual capital loss treatment, as would be a loss on section 1244 stock in excess of the $25,000-$50,000 annual limitation. Similarly, worthless indebtedness will normally give rise to short-term capital loss, unless the shareholder can prove he is in the promoting or lending business[8] or can show his loan was proximately related to another individually-owned business.[9] Within these bounds, a section 1244 pattern may emerge of using debt or preferred stock for only that part of an investment exceeding a single year's maximum ordinary loss deduction.[10]

Notwithstanding the tax insurance provided by section 1244, the risky venture may find additional advantages in qualifying under Subchapter S. Corporate net operating losses will be deductible by the *S* shareholders, with no annual dollar limits other than the amount of their total investment. Should the enterprise reach a profit stage, the *S* election will avoid the "double tax" by the provision taxing

4. See Proposed Treas. Reg. § 1.1244(a)-1 through (e)-1, 24 Fed. Reg. 8232-37 (1959).

5. At the time of adoption of the plan, $500,000 is the ceiling for the total of (a) the dollar amount to be paid for stock offered under the plan, and (b) the amount of money and other property received by the corporation after June 30, 1958 (i) for its stock, (ii) as a contribution to capital, and (iii) as paid in surplus. INT. REV. CODE OF 1954, § 1244(c) (2) (A); Proposed Treas. Reg. § 1.1244(c)-2(b).

6. INT. REV. CODE OF 1954, § 1244(c) (2) (B) (emphasis added).

7. Proposed Treas. Reg. § 1.1244(c)-1(b), 24 Fed. Reg. 8233 (1959).

8. *Compare* Giblin v. Comm'r, 227 F.2d 692 (5th Cir. 1955), *with* Comm'r v. Smith, 203 F.2d 310 (2d Cir. 1953), *cert. den.* 346 U.S. 816 (1953). See INT. REV. CODE OF 1954, § 166(d); Treas. Reg. § 1.166-5 (1959).

9. Tony Martin, 25 T.C. 94 (1955), *acq.*, 1956-1 CUM. BULL. 4; Estate of Lawrence M. Weil, 29 T.C. 366 (1957), *acq.*, 1958-2 CUM. BULL. 8. *But cf.* Gulledge v. Comm'r, 249 F.2d 225 (4th Cir. 1957).

10. A taxpayer may desire that his total investment qualify as "section 1244 stock," even in excess of a single year's $25,000-$50,000 limitation. He could then plan full use of section 1244 by selling part of his stock each year, realizing annual losses within the statutory maximum.

shareholders on their pro rata share of corporate earnings. Or, if the shareholders wish to avoid this direct taxation, regular corporate tax status may be attained by terminating the election. In all events, to be eligible under Subchapter S, there must be only one class of stock, for the issuance of a second class would immediately disqualify the election. At the same time, unlike section 1244, no statutory limitation is imposed on the net worth of an *S* corporation or the amount of its outstanding stockholder-held indebtedness. Qualifying under both Subchapter S and section 1244 may be possible under certain circumstances, thus providing greater tax flexibility.

As the foregoing indicates, both new provisions have a strong impact on the tax optimum for capitalizing corporations. Section 1244 applies only to unsuccessful undertakings; Subchapter S applies to the successful as well. Because of its broader applicability, Subchapter S will be given further consideration below with particular reference to its effect on corporate capitalization, and the pressures it exerts on issuance of corporate indebtedness.

II. Subchapter S in a Nutshell

Under Subchapter S, comprised of code sections 1371 through 1377, a "small business corporation" may elect not to be taxed as a separate entity, but to have its earnings taxed directly to shareholders and its losses directly deductible by them. To this limited extent, the new statute may be said to provide "partnership type tax treatment." Its adoption was justified on the grounds that it permits businesses to select the form of organization "without the necessity of taking into account major differences in tax consequences."[11]

To attain this special tax status, a corporation must be able to comply with all of the following requirements:

(1) It is a domestic corporation.
(2) It has only one class of stock.
(3) There are no more than ten shareholders.[12]
(4) All shareholders are individuals or estates.
(5) No shareholder is a nonresident alien.
(6) It is not a member of an "affiliated group" of corporations tied to a common parent.[13]

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11. S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958).

12. Under new subsection (c) of section 1371, husband and wife are treated as one if their stock is held as community property or in various forms of joint ownership. See note 3 *supra*. This amendment is not retroactive and is effective only for taxable years beginning on or after January 1, 1960.

13. Effective September 24, 1959, an *S* corporation will forfeit its election if it becomes a member of an "affiliated group" under the 80% test of section 1504(a). See note 3 *supra*. Previously, an election was not terminated by an *S* corporation's subsequent acquisition of 80% or more of the voting stock and of each class of nonvoting stock of another corporation. See Proposed Treas. Reg. § 1.1371-1(c), 24 Fed. Reg. 1794 (1959).

(7) It does not have disqualifying personal holding company income (*i.e.*, more than 20% of its gross receipts is *not* from royalties, rents, dividends, interest, annuities, sales or exchanges of stock or securities).

(8) It does not have disqualifying foreign income (*i.e.*, more than 80% of its gross receipts is *not* from sources outside the United States).

If the eligible corporation has made a proper *S* election,[14] which has not been terminated or revoked, it will not be subject to any income tax. This has led to its being described as a "shadow," "psuedo," "quasi," "hybrid," or "tax-option" corporation.

Under the statutory pattern, the *S* shareholder is taxed on both actual distributions of current corporate earnings and his share of any remaining "undistributed taxable income." This share is determined on the basis of his proportionate stock ownership on the last day of the corporation's taxable year, with the constructive distribution deemed reinvested so as to increase his stock basis. While the election remains in force, the shareholder may generally withdraw this previously taxed income without any tax consequences other than reducing his stock basis. After his basis has been recaptured, further withdrawals of previously taxed income will be treated as gain from the sale of his stock.

S shareholders will usually report as ordinary income their respective shares of the corporation's annual "taxable income" actually or constructively received. A single exception is made for the corporation's net long-term capital gain in excess of short-term capital loss. This portion only of the corporation's earnings retains its character in the shareholder's hands, and is reported as long-term capital gain in their individual returns—although it may in no event exceed the actual "taxable income" of the corporation for the taxable year.[15] The amount reported is in the nature of a "dividend," but is denied the 4% dividends received credit, the retirement income credit and the $50 dividends received exclusion.[16]

14. An election on Form 2553 must be executed by the corporation and filed with the district director of internal revenue, along with a statement of consent signed by each shareholder. Filing must be made during the first month of the corporation's taxable year, or during the month preceding such first month. For new corporations, "month" means the period commencing on the first day of its taxable year and ending on the close of the day preceding numerically the corresponding day of the succeeding calendar month. Proposed Treas. Reg. § 1.1372-2, 24 Fed. Reg. 1796 (1959).

15. INT. REV. CODE OF 1954, § 1375(a)(1). This contrasts with true partnerships where the full amount of capital gain carries over to the partners, with any operating loss separately available as an ordinary deduction. INT. REV. CODE OF 1954, § 702.

16. INT. REV CODE OF 1954, § 1375(b).

If the corporation has a loss year, the *S* shareholder is entitled to deduct his pro rata share, *i.e.,* "the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year."[17] However, his share of the loss may not exceed his total adjusted basis for both his stock and any corporate indebtedness held by him. Nor may he deduct any portion of a corporation's net capital loss, which apparently remains available to the corporation as a capital loss carryover for future years. On the other hand, if the shareholder does not have sufficient income of his own to offset his allowable share of the corporation's net operating loss, he may utilize it as a net operating loss carryback or carryover under code section 172.[18]

These are the highlights of Subchapter S tax treatment. While they illustrate the advantages and flexibility of the new election, they do not reveal details and complexities which are creating unexpected and extremely difficult problems.

III. Capitalizing S Corporations

Capitalizations will be simpler under Subchapter S, for under its provisions a "small business corporation" must not "have more than one class of stock." This restriction is imposed only on stock that is both issued and outstanding. A corporation will not be disqualified because of authorized but unissued stock of a different class, or because of treasury stock of a second class.[19]

Qualification as a small business corporation need not exist prior to the date of election, and election for the current year may be made at any time during the first month of such year.[20] Hence, while a corporation with outstanding preferred stock would be ineligible for the tax option, it could currently cure this infirmity by purchasing or redeeming the entire outstanding preferred issue before the close of the first month of its fiscal period. There would be no need to file articles of reduction of capital to eliminate or retire the stock, for eligibility could be attained despite the preferred stock in the treasury.

Questions undoubtedly will arise as to what is meant by a "class of stock." The proposed regulations suggest that, to be within the same class, the outstanding shares must be identical "with respect to the rights and interest which they convey in the control, profits, and assets of the corporation."[21] Disqualification, therefore, would arise from differences in voting rights as well as in dividend or liquidation

17. Int. Rev. Code of 1954, § 1374(c)(1).
18. Int. Rev. Code of 1954, § 1374(d)(1).
19. Proposed Treas. Reg. § 1.1371-1(g), 24 Fed. Reg. 1794 (1959).
20. Proposed Treas. Reg. § 1.1372-1(a)(1), 24 Fed. Reg. 1795 (1959).
21. Proposed Treas. Reg. § 1.1371-1(g), 24 Fed. Reg. 1794 (1959).

rights or preferences. Presumably this would not follow if the only difference was in par value or in some shares being without par value.

Through a liberal interpretation, the proposed regulations allow room for using a number of classes of common stock. This is permitted by the statement that "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."[22] Thus, the holders of a minority 40% of the outstanding shares may be assured of board representation in an *S* corporation by classifying their shares as Class A common stock, with the right of electing 40% of the directors. The remaining shares could be classified as Class B common stock, with the right of electing 60% of the board. However, the corporation probably would not qualify if the 40% shareholders were given the right as a class to elect a disproportionate number of directors—for example, 50% of the board. This would not seem to be "a number proportionate to the number of shares in each group."

A more subtle problem in the one-class requirement may arise from the issuance of corporate debt and its possible tax classification as "equity." While it could be argued that this equity is mere contribution to capital, the proposed regulations indicate it will be treated as a disqualifying second class of stock.[23]

In all events, the holders of stock must be individuals or estates. Persons whose stock is held by a nominee, agent, guardian, or custodian are generally considered shareholders, and such type of ownership will not defeat the election. In contrast, ownership by a partnership will not qualify, for the individual partners are not considered the shareholders.[24] Similarly ineligible is stock owned by a trustee—whether under a voting trust or under a "Clifford" trust[25] in which the grantor is treated as owner of all or part of the trust. A donee or purchaser of the stock will not be considered a shareholder unless the stock is acquired in a bona fide transaction, with the donee or purchaser being the real owner. Transactions between members of a family, it is warned, "will be closely scrutinized."[26]

IV. S CORPORATION INCENTIVES FOR CREATING DEBT

Among other things, Subchapter S has been heralded as the cure-all of "thin incorporation" difficulties. However, it would be more accurate to say it only partially alleviates the problem; for strong incentives still exist to issue debt to *S* shareholders.

22. *Ibid.*
23. *Ibid.*
24. Proposed Treas. Reg. § 1.1371-1(d) and (e), 24 Fed. Reg. 1794 (1959).
25. See INT. REV. CODE OF 1954, §§ 671-78.
26. Proposed Treas. Reg. § 1.1373-1(a) (2), 24 Fed. Reg. 1798 (1959).

True, the election does remove many of the grounds previously urged in support of corporate indebtedness. The corporation no longer requires the interest deduction to avoid "double tax," as earnings are taxable to shareholders only. Also, there is no need to incorporate "poor" to create a defense against imposition of an unreasonable accumulations surtax; for the *S* corporation is free of all income taxes, including the section 531 penalty tax. From the shareholders' viewpoint, no advantage exists in trying to fit losses into a bad debt pattern, as they are allowed ordinary deductions for the *S* corporation's net operating losses—to the extent of their basis for stock and corporate loans. Further, indebtedness no longer is the necessary vehicle for withdrawing initial investments free of a section 302(d) dividend threat. If a corporation has always operated under the *S* election, it will generally have no "earnings and profits"; distribution of original investments would then constitute a return of capital, with any amount in excess of basis treated as capital gain.[27] Nevertheless, despite the foregoing, there will be a number of reasons, nontax as well as tax motivated, why an *S* corporation will desire to create indebtedness.

1. "Locked-in" problems.—Important under Subchapter S is the nondividend status given to distributions of "undistributed taxable income" previously taxed to shareholders (referred to here as "previously taxed income" or "P.T.I.").[28] Such distributions attain special significance when the corporation has accumulated earnings and profits or when its current earnings exceed "taxable income." For while distributions are normally dividends to the extent of current or accumulated earnings, P.T.I. distributions merely reduce a shareholder's stock basis. But P.T.I. is complicated by three statutory limitations:

First, P.T.I. benefits are not transferable, and only the person who paid the tax on the original income may claim the nondividend distribution. Neither his donee, estate nor purchaser of stock may qualify. While the same *S* election is in force, however, the transferor-shareholder may regain his position by again acquiring some stock in the corporation.[29]

Second, the amounts eligible for P.T.I. distribution must be reduced by net operating losses allowable to shareholders for *prior* taxable years, as well as by previous nondividend distributions.[30]

27. INT. REV. CODE OF 1954, § 301(c)(2) and (3). Compare Proposed Treas. Reg. § 1.1375-4(a), 24 Fed. Reg. 1802 (1959).

28. INT. REV. CODE OF 1954, § 1375(d); Proposed Treas. Reg. § 1.1375-4, 24 Fed. Reg. 1802 (1959).

29. Proposed Treas. Reg. § 1.1375-4(e), 24 Fed. Reg. 1803 (1959). Contrast § 1244, where stock must be held continuously from the date of issuance if an ordinary loss is to be allowed. See Proposed Treas. Reg. § 1.1244(a)-1(b), 24 Fed. Reg. 8232 (1959).

30. INT. REV. CODE OF 1954, § 1375(d)(2).

Third, the entire P.T.I. account loses its special status forever if the Subchapter S election is terminated for any reason, *i.e.,* whether by disqualification, voluntary revocation, or nonconsent of new shareholders following death, gift or other transfer.[31]

Furthermore, under the proposed regulations, only actual distributions of *money* may be considered P.T.I. distributions.[32] Qualification is denied to distributions in kind as well as to distributions in exchange for stock and constructive distributions.

In view of the vulnerability of the P.T.I. account, therefore, the *S* corporation would be well advised to distribute before the close of each taxable year the full amount of its current taxable income. This may create practical difficulties when the corporation is short of funds, and shareholders may be requested to return distributions through various loan arrangements. A capital contribution would be inconclusive, for it would not remove dividend possibilities inherent in distributions or redemptions when there are current or accumulated earnings. The creation of bona fide indebtedness offers the best solution for this problem, assuming tax recognition is given to the transaction.

2. "Earnings and profits" problems.—A number of difficulties confront an *S* corporation because of the discrepancies between the determination of "taxable income" and "earnings and profits."[33] Percentage depletion, for example, will decrease taxable income, while earnings and profits will be reduced by only cost depletion. Again, certain receipts, like municipal bond interest and life insurance proceeds, are exempted by statute from gross income but must still be included in earnings and profits.[34] As a consequence of this disparity, and also when accumulated earnings exist, actual distributions in cash or in kind may result in dividends greater than the *S* corporation's taxable income. To afford its shareholders better tax treatment when cash withdrawals exceed the year's taxable income, a corporation might lay advance plans by issuing a significant amount of indebtedness and having these excess distributions applied in repayment of the loans.

3. Distributions in kind.—The proposed regulations under Subchapter S establish a "three-tier system" for allocating current

31. Proposed Treas. Reg. § 1.1375-4(a), 24 Fed. Reg. 1802 (1959).

32. Proposed Treas. Reg. § 1.1375-4(b), 24 Fed. Reg. 1802 (1959).

33. See generally Andrews, *Out of its Earnings and Profits: Some Reflections on the Taxation of Dividends,* 69 Harv. L. Rev. 1403 (1956); Albrecht, *Dividends and Earnings or Profits,* 7 Tax L. Rev. 157 (1952). Also, Schwanbeck, *The Accountant's Problem in Working with "Earnings and Profits" for Tax Purposes,* 10 J. Taxation 22 (1959).

34. Treas. Reg. § 1.312-6(b) and (c) (1955). *Current* earnings of an *S* corporation are not reduced by amounts not allowable as deductions in computing "taxable income." Int. Rev. Code of 1954, § 1377(b); Proposed Treas. Reg. § 1.1377-2, 24 Fed. Reg. 1804 (1959).

earnings and profits:[35] (1) the first charge is made for actual money distributions not in exchange for stock; (2) any excess earnings is next allocated ratably to both constructive distributions of "undistributed taxable income" and actual distributions in kind not in exchange for stock; and (3) finally, any earnings remaining are available for distributions in exchange for stock, such as redemption under section 302 or partial liquidation under section 331. Hence, whether or not an *S* corporation has accumulated earnings, distributions in kind in the "second tier" may result in dividends from current earnings exceeding taxable income. This could follow despite the existence of a P.T.I. account greater than the value of the property; for, under the proposed regulations, only money distributions are eligible for this nondividend treatment.[36] In such circumstances, it may be more advantageous for shareholders to "purchase" property from the corporation than to receive a distribution in kind: immediate capital gain would certainly be preferable on a short-term basis to ordinary dividends, and a prior issue of outstanding corporate indebtedness would be a convenient way to provide the consideration for such "purchase."

4. *New form of capital gain.*—An initial issue of indebtedness may also create new capital gain possibilities for *S* shareholders. Early losses might absorb the investor's basis for his stock and all or part of his basis for corporate debt. Later undistributed taxable income would increase his stock basis, but, under the faulty wording of section 1376(a), would not repair the reduced debt basis.[37] Accordingly, if the indebtedness were later sold or retired,[38] capital gain would probably follow. This would leave his proportionate stock ownership undisturbed. Also, the retirement would be free of the "essentially equivalent to a dividend" threat[39] if the indebtedness is not classified as "equity" for tax purposes.

5. *Business and estate planning.*—The "one class of stock" requirement of Subchapter S will make it impossible to use preferred stock in situations normally calling for its use. For example, an employer may want to incorporate his business and permit certain key employees to subscribe to the common stock. To reduce the value of the equity and thereby encourage greater employee participation, the employer might himself subscribe to a sizable block of a prior prefer-

35. Proposed Treas. Reg. § 1.1373-1(e), 24 Fed. Reg. 1799 (1959).

36. Proposed Treas. Reg. § 1.1375-4(b), 24 Fed. Reg. 1802 (1959).

37. See American Bar Association Section of Taxation, 1959 Program and Committee Reports to be Presented at the Twentieth Annual Meeting 90-92; Kalupa, *Remedy of Defects in Subchapter S Asked by ABA Taxation Committee,* 11 J. TAXATION 196 (1959).

38. INT. REV. CODE OF 1954, § 1232(a)(1).

39. INT. REV. CODE OF 1954, § 302(b)(1) and (d).

ence, nonvoting security.[40] Similarly, in estate planning, the controlling shareholder might prefer a fixed income, nonvoting security for his wife and daughters, while giving common stock to children active in the business. Under Subchapter S, only corporate indebtedness would be available for accomplishing these legitimate business and estate planning desires.

V. CONCLUSION

The incentives are many for using indebtedness in capitalizing an *S* corporation. Remaining are all of the frustrating and conflicting decisions seeking to draw the line between "equity" and "debt" in closely-held enterprises. On this occasion, however, the problem assumes new and more serious forms.

To preserve the integrity of P.T.I., cash will often be distributed before the year's end followed by a series of return loans. The resulting distribution-lendback pattern undoubtedly will excite both the curiosity of the Internal Revenue Service and the inventiveness of the courts. Should the combined transactions be telescoped or disregarded as a "sham"?[41] Should they more realistically be treated as distributions of corporate obligations?[42] Or should they be regarded as contributions to capital rather than true loans? On the other hand, even if the "lendback" bears all the formalities of corporate indebtedness, might not the arrangement be categorized as creating "equity" under the thin incorporation doctrine?[43]

But whether indebtedness is created to handle P.T.I. or whether it is placed in the initial capital structure for other reasons previously suggested, its ultimate tax classification as "debt" or "equity" is extremely crucial under Subchapter S. For a determination that "equity" was intended may be treated as the equivalent of creating a second class of stock which would disqualify the election in its entirety under the "one class of stock" rule.[44] Retroactive disqualification under what is found to be a mistaken election, perhaps covering a number of years, could have dire tax consequences.

Congress is considering the advisability of establishing certain debt-equity norms. Section 10 of H.R. 4459, introduced in the last session of Congress, would create new Code section 317(c) defining "indebtedness."[45] The definition would be non-exclusive, but at the same time would provide reasonable certainty in this hazy area. Assuming

40. *Cf.* J. I. Morgan, Inc., 30 T.C. 881, (1958), *acq.*, 1959 INT. REV. BULL. No. 5, at 6.
41. Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945); Gregory v. Helvering, 293 U.S. 465 (1935); *cf.* Bazley v. Comm'r 331 U.S. 737 (1947).
42. *Cf.* Proposed Treas. Reg. § 1.1373-1(d), 24 Fed. Reg. 1799 (1959).
43. See Caplin, *supra* note 1.
44. Proposed Treas. Reg. § 1.1371-1(g), 24 Fed. Reg. 1794 (1959).
45. 86th Cong., 1st Sess. (Feb. 12, 1959).

straightforward indebtedness—absolute promise to pay sum certain in money, reasonable interest and reasonable maturity, no subordination or voting privileges, etc.—the proposed statute would automatically recognize the debt in ratios up to five to one, five parts debt held or guaranteed by shareholders to one part equity. If the ratio went beyond this, the taxpayer would not be completely stymied; for he would still have the opportunity to meet his usual burden of proof to establish the tax validity of the purported indebtedness.

Before adopting this or similar legislation, Congress would be well advised to test the adequacy of the "indebtedness" definition against the peculiar problems of Subchapter S. Consideration might also be given to the American Bar Association proposal to provide relief when a corporation mistakenly assumes it is qualified under Subchapter S and thereafter makes a distribution of earnings to shareholders.[46] To avoid the "double tax," the A.B.A. would permit these *S* shareholders to return the distribution to the corporation and thereby eliminate the second tax. This provision, comparable to code section 1341 for amounts received under claim of right, would be of particular aid on the debt-equity issue. For while the use of indebtedness continues to be valuable to *S* corporations and their shareholders, a mistake in accurately forecasting its tax classification today carries tax penalties of unwarranted severity.*

46. See authorities cited note 37 *supra.*

*On December 18, 1959, following the completion of this article, the final regulations for tax-option corporations were adopted. See Treas. Reg. §§ 1.1371-1 through 1.1377-3 (1959). While some significant changes were made in the regulations as originally proposed, none of the modifications affects any of the statements or conclusions contained in this article. *Cf.* the author's forthcoming article, "Subchapter S vs. Partnership: A Proposed Legislative Program," to be published in the *Virginia Law Review.*