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Indiana Law Journal

Volume 52 | Issue 4 Article 9

Summer 1977

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Jeffrey K. Riffer
Indiana University School of Law

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Recommended Citation
Riffer, Jeffrey K. (1977) "Financial Corporations and Subchapter S: An Interesting Problem," *Indiana Law Journal*: Vol. 52 : Iss. 4 , Article 9.
Available at: http://www.repository.law.indiana.edu/ilj/vol52/iss4/9

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Financial Corporations and Subchapter S: An *Interest*ing Problem

Subchapter S[1] of the Internal Revenue Code was enacted in 1958 with the stated purpose of permitting businesses to select the form of organization desired without having to take into consideration major differences in tax consequences.[2] Unfortunately, small financial corporations have been effectively denied the benefits[3] of the subchapter S option by a series of adverse court determinations and Internal Revenue Service regulations. The essence of these determinations and regulations is that financial corporations cannot meet the requirements of the income test contained in subsection 1372(e)(5) of the Internal Revenue Code because their income is derived primarily from interest received on loans. This income, it is reasoned, is a form of proscribed revenue which terminates the subchapter S election if it comprises more than twenty percent of the gross receipts of the corporation. The subject of this note is to determine whether the congressional intent in regard to this income test has been correctly interpreted, and therefore, whether financial corporations should be precluded from electing subchapter S because of the nature of their income, assuming that all other requirements for the election are met.[4]

THE PROBLEM: THE AMBIGUITY OF SUBSECTION 1372(e)(5)

Legislative History and Administrative Interpretation

Subchapter S became law with the enactment of the Technical Amendments Act of 1958.[5] As previously mentioned,[6] the purpose of the subchapter was to permit the selection of the form of doing business, *e.g.* corporation,

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[1]I.R.C. §§ 1371-1379.

[2]S. REP. No. 1983, 85th Cong., 2d Sess. 87, *reprinted in* 1958 C.B. 922, 1008.

[3]There are three major reasons why a corporation can benefit from electing subchapter S. First, and probably most important, is the elimination of the corporate tax liability, thereby avoiding the double taxation of corporate earnings. The firm's earnings are deemed to be distributed pro rata to the stockholders, who pay only their individual tax on this income. I.R.C. § 1373(a). Second, subchapter S allows the shareholders to report the corporation's net operating loss on their personal returns. I.R.C. § 1374(b). This deduction is allowed for the year of its occurrence with a three year carryback and a seven year carryforward. I.R.C. § 172(b). Without the election, these corporate net operating losses would be deductible only by the corporation. A shareholder would reap a tax benefit only if the losses were so great that they bankrupted the firm, in which case the shareholder could report a capital loss in a worthless security. I.R.C. § 165(g). Third, the corporation's capital gains retain their character when they are passed through to the shareholders as real or constructive dividends. I.R.C. § 1375(a)(1). Further, I.R.C. § 1231 (basically, non-inventory property of a trade or business) gains are passed through as capital gains and therefore do not offset the shareholder's own § 1231 losses. B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 6-22 (3d ed. 1971).

[4]For the other miscellaneous tests which must be satisfied see I.R.C. §§ 1371 and 1372.

[5]Pub. L. No. 85-866, 72 Stat. 1606 (1958).

[6]See note 2 *supra* & text accompanying.

partnership or individual proprietorship, to be made without consideration of the major differences in tax treatment which would otherwise inhere in these different forms. Unfortunately, the draftsmanship was hurried, and because no hearings were held, the origins of many provisions are obscure.[7]

Subsection 1372(e)(5) imposes a restrictive income test on those corporations which opt to elect subchapter S. This subsection, originally entitled "Personal holding company income," provides that a corporation's subchapter S election terminates if the corporation "has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. . . ."[8] The 1958 committee reports give no explanation for the personal holding company income limitation.[9] In fact, an earlier Senate Finance Committee report does not even mention an income test as being one of the criteria for a valid subchapter S election.[10]

In 1966, for reasons which are not entirely clear, Congress amended subsection 1372(e)(5).[11] The subsection was retitled, substituting "Passive investment income" for "Personal holding company income." The committee reports issued contemporaneous with and subsequent to the 1966 amendment provide insight only into the general congressional intent involved in enacting the whole of subchapter S. A report issued by the Senate Finance Committee in 1966, for example, noted that the congressional intent when enacting subchapter S was to include only small businesses actively engaged in a trade or business.[12] This view was reiterated in 1970 when the Senate Finance Committee stated that Congress intended subchapter S to be applicable solely to operating firms.[13]

In light of this general intent, the most probable reason[14] for the restrictive income test of subsection 1372(e)(5) is to reduce the possibility of utilizing subchapter S to minimize the costs of incorporating passive investment activities while obtaining the tax benefits normally accorded only to corporate

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[7]Hewitt, *Some Intriguing Recent Developments in Subchapter S,* 44 TAXES 848, 848 (1966).

[8]I.R.C. § 1372(e)(5).

[9]*See* S. REP. NO. 1983, 85th Cong., 2d Sess. 87, *reprinted in* 1958 C.B. 922.

[10]*See* S. REP. NO. 1622, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4623.

[11]I.R.C. § 1372(e)(5), *as amended by* Pub. L. No. 89-389, § 3(a), 80 Stat. 114 (1966). No reason was given in the committee reports for the name change. *See* S. REP. NO. 1007, 89th Cong., 2d Sess. 1154 *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2141.

[12]See S. REP. NO. 1007, 89th Cong., 2d Sess. 1154, *reprinted in* [1966] U.S. CODE CONG. & AD NEWS 2141, 2148.

"Although a committee report written with regard to a subsequent enactment is not legislative history with regard to a previously enacted statute, it is entitled to some consideration as a secondarily authoritative expression of expert opinion." Bobsee Corp. v. United States, 411 F.2d 231, 237 n. 18 (5th Cir. 1969).

[13]S. REP. NO. 91-1535, 91st Cong., 2d Sess., *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 6098, 6099.

[14]One commentator has speculated that the Treasury has become so accustomed "to lambasting personal holding companies and Congress is so used to depriving them of tax protection," that the "conventional wisdom" requires that they be prohibited from electing subchapter S even if the result is nonsensical. See Borsook, *Few Personal Holding Companies Will Qualify for Subchapter S Election,* 10 J. TAX. 19, 19 (1959).

business forms.[15] This "incorporated pocketbook" objection is not new; both the IRS and the Treasury have made their position on such attempts clear for some time.[16]

Given the lack of any specifically enunciated congressional intent in connection with the income test of subsection 1372(e)(5) and the potential for abuse of subchapter S through such devices as the "incorporated pocketbook," it is not surprising that the IRS promulgated regulations importing a restrictive interpretation to the subsection. It is this interpretation of the income test which assists the courts in denying small financial corporations the benefits of a subchapter S election. The IRS' very literal interpretation provides basically that all interest, regardless of how it is earned, is passive investment income under subsection 1372(d)(5). Obviously, a small financial corporation which has interest income as its primary, if not exclusive, source of revenue can never meet the income test of subsection 1372(e)(5), and therefore can never elect subchapter S given the current administrative interpretation. Furthermore, attempts to challenge these regulations have met with limited success in the courts.

Judicial Interpretation

Following the Treasury regulations, and struggling with the inherent ambiguities in the statute, the courts construing subsection 1372(e)(5) have generally denied the subchapter S election to financial corporations. The Tax Court has been especially adamant in preserving this interpretation. A brief review of a sampling of subsection 1372(e)(5) cases best illustrates the trouble which the courts have had in deciding this issue.

In two recently decided cases[17] which arose prior to the 1966 amendment of subsection 1372(e)(5), the Tax Court decided factually identical situations differently. This legal legerdemain was made possible by application of the *Golsen*[18] rule which states that the Tax Court will follow the holdings of the taxpayer's circuit court of appeals. While the taxpayers involved in the two cases were shareholders in the same small finance company which had elected subchapter S, they resided in different federal judicial circuits.

In the first case, the taxpayer, Puckett, was subject to the jurisdiction of the Fifth Circuit Court of Appeals. The Fifth Circuit, prior to the Tax Court's determination in the instant case, had held in *House v. Commissioner*[19] that the pre-1966 subsection heading "Personal holding company income" meant that only personal holding company income was proscribed. Since the Code's personal

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[15]*Id.* For further analysis see text accompanying notes 81-83 *infra.*

[16]Hewitt, *Some Intriguing Recent Developments in Subchapter S,* 44 TAXES 848, 859 (1966).

[17]Kenneth W. Doehring [1974] 43 T.C.M. (P.H) ¶ 74,234 (subchapter S election disallowed), *rev'd* 37 A.F.T.R.2d. 76-396 (8th Cir. 1975), and Paul E. Puckett, [1974] 43 T.C.M. (P-H) ¶ 74, 235 (subchapter S election allowed), *aff'd* 522 F.2d 1385 (5th Cir. 1975). Thus, both taxpayers were ultimately allowed to make the subchapter S election.

[18]Jack E. Golsen, 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir.), *cert. denied* 404 U.S. 940 (1971).

[19]453 F.2d 982 (5th Cir. 1972).

holding company provisions provide that financial corporations which derive more than sixty percent of their ordinary gross income from the active conduct of a business are not considered personal holding companies, the Fifth Circuit reasoned that the interest revenue of a financial corporation would not serve to terminate a subchapter S election.[20] The Tax Court, therefore, following the *Golsen* rule, did not terminate the election as to Puckett, the Fifth Circuit resident, because for him the interest earned by his small loan company was not considered to be proscribed.

In the second case, however, the taxpayer, Doehring, was a resident of the Eighth Circuit. The Tax Court was free in this case to decide the issue on its own since the Eighth Circuit Court of Appeals had never ruled on the question. The Tax Court determined that the interest income terminated the corporation's subchapter S election, thus denying subchapter S treatment for Doehring. Although the Eighth Circuit subsequently reversed the Tax Court, the case remains significant for two reasons: First, it indicates the position of the Tax Court and second, the Eight Circuit's opinion was expressly limited to cases arising prior to the 1966 amendment.

Although the number of future cases involving subchapter S elections made when the heading was "Personal holding company income" will be insignificant,[21] the importance of the general issue survives. Small financial corporations should be allowed to elect subchapter S treatment. Moreover, it is possible that without reasoned legislative or judicial guidance, the *Doehring-Puckett* anomaly could occur again. Assume, for example, the identical fact situation except in a post-1966 setting. It is quite likely that the Fifth Circuit would allow a financial corporation to elect subchapter S, citing the strong dicta of *House v. Commissioner* that interest earned from an active business is not proscribed "passive investment income."[22] It is equally likely that the Eighth Circuit would disallow the election because of the specific language in *Doehring v. Commissioner* limiting the election for financial corporations to pre-1966 years.[23]

The sole case dealing with the post-1966 subsection, *Marshall v. Commissioner*,[24] was decided without an in-depth analysis either of the reason for the 1966 amendment or of the terms "gross receipts" and "interest" used in the statute. The *Marshall* court argued that when Congress changed the title of subsection 1372(e)(5) from "Personal holding company income" to "Passive investment income" it effected a substantive change in the law.[25] The court reasoned that since finance companies are specifically exempt from the per-

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[20] *Id.* at 987.

[21] Note, however, that while the tax years involved in the *Puckett* and *Doehring* cases were 1962 and 1963, the Tax Court did not decide these cases until 1974 and the circuit courts' decisions were rendered in 1975.

[22] House v. Commissioner, 453 F.2d 982, 987 (5th Cir. 1972).

[23] Doehring v. Commissioner, 37 A.F.T.R.2d 76-396, 76-399 (8th Cir. 1975).

[24] 510 F.2d 259 (10th Cir. 1975). The circuit court held that the interest earned by the loan department of a corporation was passive income within the meaning of subchapter S and thereby precluded a subchapter S election.

[25] *Id.* at 263.

sonal holding company rules, if the pre-1966 "Personal holding company" title used by subsection 1372(e)(5) was meant to refer to the other personal holding company provisions,[26] it should have followed that finance companies be allowed subchapter S treatment. The court then asserted that the 1966 revision of the subsection heading could "only be seen as Congress' calculated effort to erase utterly any implication that a small corporation must be a personal holding company before it can be excluded from Subchapter S treatment" by section 1372.[27] At another point the court stated that this name change would have been "completely pointless" had Congress not originally attached some value to the title "Personal holding company income."[28]

While the *Marshall* court's holding that a substantive change occurred in 1966 is plausible, it does not seem to be the most reasonable interpretation of the name change. There are three reasons which support the contention that the title change was not meant to affect the statute substantively. First, while it is logical to conclude that an amendment to an unambiguous statute indicates an intent to change the law, no such inference arises when the legislature amends an ambiguous provision.[29] Clearly, the differences between the two sections both entitled "Personal holding company" were significant[30] and made the meaning of subchapter S ambiguous. The change in name may have been made to prevent such confusion.[31]

Second, Congress gave no reason for the change.[32] Considering there were no court cases interpreting subsection 1372(e)(5)'s title "Personal holding company income," Congress could not have intended to change any judicial construction of the act.[33] It seems difficult to believe that a major change was intended in the absence of any enunciated congressional desire and when there could be no case law to overrule.

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[26] I.R.C. § 542(c)(6).

[27] Marshall v. Commissioner, 510 F.2d 259, 263 (10th Cir. 1975).

[28] *Id.* This conclusion was quoted, with approval, in Doehring v. Commissioner, 37 A.F.T.R.2d 76-396, 76-399 n. 8 (8th Cir. 1975) (dictum).

[29] Taylor v. Crisp, 286 N.C. 488, 497, 212 S.E.2d 381, 387 (1975) *quoting* Childers v. Parker's, Inc. 274 N.C. 256, 260, 162 S.E.2d 481, 484 (1968).

The fact of amendment does not indicate whether the change is of substance or form. 1A SUTHERLAND STATUTORY CONSTRUCTION § 22.30 (4th ed. 1972).

[30] First, the qualifying tests are different. To elect subchapter S, less than twenty percent of a firm's gross receipts must be from specific income, while to be considered a personal holding company more than sixty percent of a firm's adjusted ordinary gross income must be from certain types of income. I.R.C. §§ 1372(e)(5), 542(a)(1). Second, certain specifically named income for one subchapter's purposes is not proscribed income for the other subchapter. Gains from the sale of stock or securities are tainted for subchapter S, but do not affect the personal holding company provisions. I.R.C. §§ 1372(e)(5), 543(a), (b)(1). Third, the quantum of similar income is treated differently. Rents and royalties are always passive subchapter S income; however, if they exceed fifty percent of the firm's ordinary gross income they are not considered personal holding company income. I.R.C. §§ 1372(e)(5), 543(a)(2), (3), (4).

[31] Note, *An Approach to Legislative Revision of Subchapter S,* 26 TAX L. REV. 799, 817 (1971).

[32] *See* S. REP. NO. 1007, 89th Cong., 2d Sess. 1154, *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 2141.

[33] The first decision on this subject was in Valley Loan Ass'n v. United States, 258 F. Supp. 673 (D. Colo. 1966), rendered five months after the subsection title was changed.

Third, apparently even the Treasury did not feel there was a change because no new regulations were promulgated to explain the meaning of the new subsection heading.[34] This would be unusual behavior if the Treasury thought a significant modification of the statute had occurred.

Marshall's assertion that the 1966 name change affected substantive rights does not appear persuasive when contrasted with the three factors which weigh against that proposition. However, even if a change was intended by this renaming of the subsection, *Marshall's* conclusion that loan companies cannot elect subchapter S does not appear warranted. The title was changed to "Passive investment income" which, at least on its face, should apply to passive, non-operating businesses, rather than to active loan companies.

A PROPOSED SOLUTION

Financial corporations should not be precluded from electing subchapter S for two reasons. First, loan repayments should be included in the meaning of "gross receipts." This would have the effect of increasing the base figure so that these firms would pass[35] the twenty percent passive income test. While the present Treasury regulations exclude these loan repayments from gross receipts, the regulations should not be upheld because they are unreasonable and inconsistent with the statute. Second, even if loan repayments are not considered gross receipts, an election should be possible because "interest," when used in the passive investment income limitation section,[36] was not meant to include interest earned on loans by an active lending institution.

Gross Receipts

"Gross receipts" is defined neither in the statute nor in the committee reports. The regulations define it as the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income.[37] It expressly excludes amounts received as repayment of an outstanding loan.[38]

Treasury regulations must be sustained unless they are unreasonable and plainly inconsistent with the revenue statutes.[39] They constitute contemporaneous constructions by those charged with the administration of such statutes and should not be overruled in the absence of compelling reasons.[40] Nevertheless, this regulation should be overruled.

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[34] *See* Treas. Reg. § 1.1372-4 (1958).

[35] Care should be taken so that "pass" is not misunderstood. The statutory test provides that if more than twenty percent of a firm's gross receipts is derived from passive investment income a subchapter S election cannot be made. "Pass" is meant to indicate that a firm qualifies for election under this test, *i.e.*, that its passive income is less than twenty percent of its gross receipts.

[36] I.R.C. § 1372(e)(5)(C).

[37] Treas. Reg. § 1.1372-4(b)(5)(iv)(a) (1958).

[38] *Id.*

[39] United States v. Cartwright, 411 U.S. 546, 557 (1973).

[40] Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948).

First, this regulation unreasonably discriminates in favor of corporations which sell from inventories. By using a gross receipts test instead of a gross income[41] test, Congress gave added assurance that a business which sold from inventory would not suffer a revocation in the event that it temporarily sold its goods below cost. There would still be gross receipts to increase the base for passing the twenty percent test, even if the corporation had no gross income.

In substance, there seems to be little difference between the recoupment of the cost of goods sold in gross receipts for firms selling inventory, and the repayment of principal for firms "selling" the time value of money. However, the regulation's specific exclusion of loan repayments from gross receipts will preclude finance companies from electing subchapter S for the following reason. With loan repayments excluded, the primary source of receipts for financial corporations is interest. Since total gross receipts will be substantially composed of proscribed income, finance companies will continually fail the twenty percent test.

Congress did not show any intent to discriminate in favor of firms with inventories. Its only stated purpose was to allow small businesses to elect subchapter S.[42] Therefore, in the absence of a congressional desire to discriminate in favor of firms with inventories, and where there is no substantive economic difference between companies,[43] the regulation should not be upheld. Admittedly, the test for overruling regulations, that the regulations must be "unreasonable and inconsistent with the statute," is conclusory. However, a regulation which treats economically similar enterprises differently, when Congress did not intend such disparate treatment, should plainly meet this test.

Second, Congress carved its exceptions from the definition of gross receipts when it restricted the gross receipts from the sale or exchange of securities to gains only rather than permitting inclusion of the gross sales price, and when it excluded amounts received under section 331[44] if the electing corporation owned more than fifty percent of the liquidating corporation.[45] The maxim *expressio unius est exclusio alterius*[46] implies that had Congress wanted to exclude loan repayments from gross receipts, it would have so specified in the statute.

Third, the regulation is internally inconsistent. "Gross receipts" is defined as the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income.[47] It should be noted that

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[41]Gross income from sales is gross receipts less cost of goods sold.

[42]*See* S. REP. NO. 1983, 85th Cong., 2d Sess. 87, *reprinted in* 1958 C.B. 922, 1008.

[43]*See* notes 69 and 70 *infra* & text accompanying.

[44]I.R.C. § 331 states that amounts distributed in complete or partial liquidation of a corporation shall be treated as payments in exchange for the stock. This means that such exchanges will be accorded capital gain or loss treatment.

[45]I.R.C. § 1372(e)(5)(C).

[46]To mention specific exceptions to a general rule is to preclude all others. While this principle is an aid to statutory construction, it is not a rule of law. It can never override clear and contrary evidence of congressional intent. Neuberger v. Commissioner, 311 U.S. 83, 88 (1940).

[47]Treas. Reg. § 1.1372-4(b)(5)(iv) (1958).

receipts representing the adjusted basis of property are nontaxable income.[48] They are a return of capital, which has always been excluded from gross income. The tax-free return of capital rule provides an exclusion from income, not a deduction; such receipts are therefore never accrued in computing a corporation's taxable income.[49]

Since the regulation considers these tax-free revenues representing a return of capital as gross receipts for sales of property,[50] the nontaxable return of capital funds from the repayment of the loan principal[51] should also logically be includable as gross receipts in "sales" of the time value of money.[52] Thus, the regulation provision which excludes repayment of loans from gross receipts conflicts with its example which includes funds representing a return of capital in that definition.[53] Internal inconsistency in a Treasury regulation significantly impairs its value as an aid to the interpretation of a statute,[54] and therefore, such a regulation should not be followed.

The case of *Marshall v. Commissioner*[55] has sustained this regulation, holding that it is not inconsistent with the subchapter S statute. The circuit court felt that when Congress changed the name of subsection 1372(e)(5) from "Personal holding company income" to "Passive investment income" in

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[48]This has been undisputed since Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918).

[49]Yet, in contravention of the regulations, tax-free revenues which would therefore not be accrued as gross income can still result in gross receipts for that tax year. In Branch v. United States, 67-2 U.S.T.C. ¶ 9636 (N.D. Ga. 1967) the court held that option payments actually received in the tax year were gross receipts even though they were not taxable income until the year in which the option either expired or was excercised. Of course, while these option payments are considered gross receipts in a year when they are tax-free, they certainly do not represent a return of capital.

Similarily, the court in Buhler Mortgage Co. 51 T.C. 971, 976 (1969), *aff'd per curiam* 443 F.2d 1362 (9th Cir. 1971), stated in dictum that tax-free revenues, the proceeds of notes sold to a third party at a loss, would unquestionably be included in gross receipts. The court held, however, that these notes were "securities" and therefore because the statute specifically limited the gross receipts from the "sale or exchange" of securities to gains, no gross receipts resulted from this sale at a loss.

It should be noted that a broad reading of *Buhler*, that notes are always "securities" and therefore the gross receipts from loan payments should be limited to gains, *i.e.*, interest, is precluded by case law. The payment and discharge of a note is neither a "sale" nor an "exchange." Fairbanks v. United States, 306 U.S. 436, 437 (1939); Riddell v. Scales, 406 F.2d 210, 212 (9th Cir. 1969).

[50]Example (1) in Treas. Reg. § 1.1372-4(b)(5) (1958) illustrates that gross receipts are not reduced by the adjusted basis of property when the property is sold.

[51]Rosenberg v. United States, 21 A.F.T.R.2d 788, 789 (C.D. Cal. 1968).

[52]Alfred M. Sieh, 56 T.C. 1386, 1392 (1971) *aff'd without opinion* 73-1 U.S.T.C. ¶ 9281 (8th Cir. 1973), stated in dictum that payments on principal are considered part of gross receipts for a firm whose principal trade or business is financing.

[53]Treas. Reg. § 1.1372-4(b)(5) (1958), example (1).

[54]United States v. Calamaro, 354 U.S. 351, 359 n. 12 (1957). The defendant, who transferred wager records from the initial collectors of the wagers to the party against whom the players bet, was convicted of failure to pay a special occupational tax on "receiving wagers." The Treasury regulation which accompanied this statute considered record transferors such as the defendant liable for the tax in one of its examples. However, in an earlier example, the regulation exempted secretaries and bookkeepers from the act, drawing a distinction between receiving "wagers" and receiving "receipts of wagers for accounting purposes." The Court ignored the regulation noting that it was internally inconsistent because its distinction between receiving wagers and receiving receipts of wagers could not be valid regarding record transferors and other recorders.

[55]510 F.2d 259 (10th Cir. 1975).

1966, it indicated that the subsection should apply to business operations other than personal holding companies.[56] Thus, financial corporations, although exempt from the personal holding company provisions,[57] would not be allowed to elect subchapter S because of the requirements of section 1372.

A more likely explanation for this name change, since it was accompanied by no judicial construction of the term "personal holding company income," no indication by Congress that a substantive right was being affected, and no new regulations promulgated by the Treasury to cover this different name, would be that no substantial change was intended.[58] The name change was probably made to avoid confusion, since there were significant differences between the personal holding company income defined in subsection 1372(e)(5) and the personal holding company provisions of sections 542 and 543.[59]

However, even if *Marshall's* conclusion that the subsection applies to business firms other than personal holding companies is correct, it does not follow that financial corporations cannot elect subchapter S. Congress chose to title the election-terminating revenues "passive investment income," which appears to be in contradistinction to active business income. Under this interpretation, a loan company, an active business, would not be precluded from electing subchapter S; only firms with passively earned investment income which exceeded twenty percent of their gross receipts would have their elections disqualified.

Further, *Marshall* approved the regulation because it precludes a corporation from manipulating its gross receipts by artificial transactions which have no effect on its real income.[60] Absent this regulation, the court hypothesized that a corporation, realizing that its passive investment income would exceed twenty percent of its gross receipts, would simply make a short-term loan, which does not decrease its gross receipts, and then take repayment in time to inflate its gross receipts for the tax year.[61] By its own words, *Marshall* supports the regulation only because it prohibits sham transactions. However, the remedy is too drastic for the putative harm because as written, the regulation prevents even bona fide loan repayments from increasing gross receipts. A far better solution to allay the fears of the *Marshall* court would be to scrutinize the substance of the transaction.[62] This would allow gross receipts to be increased if the transaction were a bona fide loan repayment, but not if it were a sham.[63]

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[56] *Id.* at 263.

[57] I.R.C. § 542(c)(6).

[58] For an analysis of the meaning of this name change, see text accompanying notes 29-34 *supra*.

[59] *See* notes 30 and 31 *supra* & text accompanying.

[60] Marshall v. Commissioner, 510 F.2d 259, 263 (10th Cir. 1975).

[61] *Id.*

[62] It is beyond peradventure in tax law that substance should control over form. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

[63] While the details of different sham transactions are probably infinitely diverse, one example illustrates the possibilities. Company *A*, with large cash balances, on December 29 has passive investment income exceeding twenty percent of its gross receipts and later that day makes a large,

Interest

"Gross receipts" as presently defined by the regulations would not prevent a subchapter S election by small loan companies if interest earned on loans was not proscribed by subsection 1372(e). At first glance it would appear obvious that interest earned on loans is the type of interest mentioned in this subsection entitled "Passive investment income." However, words in the Code sometimes have very unusual meanings.[64]

"Interest" is not defined in subchapter S. The regulations define it as any amount received for the use of money,[65] but the regulations are inconsistent in this area. In defining "rents," another of the election-terminating passive revenues, the Commissioner specifically excludes payments for the use of rooms or space where significant services are also rendered.[66]

There can be no logical reason that rents from an active business, with certain modifications, will not be considered proscribed "rent," while interest from an active business[67] will always be disqualifying "interest." As noted before, courts ignore internally inconsistent regulations,[68] and little credence should be given to this regulation.

Since the regulation's definition should not be followed, a closer look must be taken at the statute itself. By the wording of its title, "Passive investment income," the subsection indicates that Congress perceived something particularly "passive" in the receipt of interest, as well as the five other types of proscribed income,[69] which does not exist with regard to other revenues. This simply does not comport with reality. There is nothing more passive about the receipt of interest (and principal) when a firm is "selling" the time value of money than the receipt of sales revenue when a company is selling inventory. Both businesses must "buy" their "inventory." A manufacturing plant does this in the form of payments for labor and material while the financial corporation "buys" the use of funds by paying interest on various types of savings accounts and certificates of deposit. The selling price of in-

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interest-free loan to a "sister" corporation, requiring repayment by the following day. This loan arrangement should certainly not be considered bona fide.

[64]*See, e.g.,* I.R.C. § 751(d)(2)(B) where inventory is defined to include accounts receivable.

[65]Treas. Reg. § 1.1372-4(b)(5)(vii) (1958).

[66]Treas. Reg. § 1.1372-4(b)(5)(vi) (1958). The regulation modifies the common sense meaning of rent; these significant services must be other than those usually rendered in connection with the rental of rooms. The Commissioner, in promulgating Rev. Rul. 65-91, 1965-1 C.B. 431, has further complicated this area. That ruling lists four fact situations and states whether each situation fits the definition of rent. It gives no support for its conclusions, which are not obvious and are truly of a generalization-defying nature.

[67]Active and passive businesses can best be understood as different points on a continuum. A loan company would be considered an active business if it had numerous employees, paid rent for office space, screened loan applicants for risks, negotiated interest rates and had a bevy of collection attorneys ready if the debtor defaulted. In contrast, a corportion whose only business consisted of one shareholder-employee who, quarterly, took a passbook to the bank so the interest could be recorded would be considered a passive business.

[68]United States v. Calamaro, 354 U.S. 351, 359 n. 12 (1957). *See* note 54 *supra*.

[69]Rents, royalties, dividends, annuities, and sales or exchanges of stock or securities. I.R.C. § 1372(e)(5).

ventory by the manufacturing firm is theoretically composed of the cost of goods sold and a gross profit. Similarly, the lending institution requires repayment of principal, basically its "cost of goods sold," plus interest, primarily the gross profit.[70]

The question is reduced to one of identifying which receipts Congress intended to vitiate the election. There is little doubt that if Congress meant to define passive investment income to include both interest of a passive nature and interest derived from the active conduct of a business it could so legislate.[71] In determining what Congress intended,[72] there is nothing sacrosanct about the wording of the definition included in the act. Definitions are themselves written in words whose meanings, whether viewed separately or in conjunction with the terms being defined, may be determinable only through interpretation.[73] The Supreme Court has repeatedly noted that words used in definition sections also need further defining[74] and that the object intended to be reached by the act must limit and control the literal import of the terms and phrases employed.[75] Congressional word choice is no talisman to be slavishly followed if the intent of that body would indicate a contrary result. Judge Learned Hand wrote:

> [T]he colloquial words of a statute have not the fixed and artificial content of scientific symbols. They have a penumbra, a dim fringe, a connotation, for they express an attitude of will, into which it is [the court's] duty to penetrate

[70]More precisely, the gross profit of a financial corporation is the difference between the cost of its money and the interest earned on this particular loan. For example, if company *A* has savings accounts and certificates of deposit as well as outstanding common stock, preferred stock and short-term and long-term bonds, it will have a certain cost of capital. The difference between that cost of capital and the interest rate on this loan should be the firm's gross profit. The profit is not the entire interest rate earned on the loan, it is just the difference between the rate charged and the cost of capital. For further discussion of the components of a firm's cost of capital, see A. BONESS, CAPITAL BUDGETING 44-66 (1972) and B. MOORE, AN INTRODUCTION TO THE THEORY OF FINANCE 84-88 (1968).

[71]However, at least one court has spoken out against this type of "loose" definition. In United Interchange v. Spellacy, 144 Conn. 647, 655, 136 A.2d 801, 805 (1957), the court wrote that it was questionable whether a legislature could, by defining as a dog an animal having the components of a horse, subject the owner of a horse to the dog licensing statute.

[72]This does not mean what was in the minds of congressmen. The chance that several hundred members of Congress each had the litigated issue in mind as a possible reduction from the statute is infinitesimally small. The chance is still smaller that the litigated issue was not only in the minds of all these members but that they had also reached a conclusion about it. Radin, *Statutory Construction*, 43 HARV. L. REV. 863, 870 (1930).

[73]2A SUTHERLAND STATUTORY CONSTRUCTION § 47.07 (4th ed. 1972).

[74]*See, e.g.*, Farmers Reservoir & Irrigation Co. v. McComb, 337 U.S. 755 (1949); Western Union Tel. Co. v. Lenroot, 323 U.S. 490 (1945).

[75]Church of the Holy Trinity v. United States, 143 U.S. 457, 460 (1892). In the ensuing eight decades the Court has consistently held that congressional intent will prevail over the literal meaning of the words of the statute. *See* Philbrook v. Glodgett, 421 U.S. 707, 713 (1975); United States v. Campos-Serrano, 404 U.S. 293 (1971).

There may be limits to the extent that congressional intent can override the words of the statute. For example, if Congress used the word "white" in a statute, the courts could hardly construe the word as meaning "black", even if a congressional report gave it that meaning. R. PAUL, TAXATION IN THE UNITED STATES 434 (1954).

> and which [judges] must enforce ungrudgingly when [they] can ascertain it, regardless of imprecision in its expression.[76]

The Supreme Court has stated that there is no sound reason to look only at the text, even when a statute's meaning seems obvious and that there is no rule of law forbidding resort to explanatory legislative history no matter how clear the words may appear on superficial examination.[77] In this case, care should be taken in construing the word "interest" in all cases as a type of passive investment income.

There are two primary methods of ascertaining legislative intent. First, consideration should be given to the committee reports which were written by the congressmen who drafted the act.[78] As was noted previously, the committee reports for section 1372 indicate that operating businesses should be allowed to elect subchapter S.[79] Therefore, since the intent of Congress should control over the literal meaning of the statute's words, subchapter S's passive investment income limitations should apply solely to passive nonoperating firms and not to active loan companies, which should be allowed to make the election.

A second guide to the meaning of a statute can be found in its purpose.[80] The harm to be stopped by the exclusion of passive income in subsection 1372(e)(5) was the possibility of incorporating personal investment activities, electing subchapter S, and obtaining the tax deferral benefits accorded to pension and profit-sharing plans without any additional tax cost.[81] The tax advantage here is that payments to these plans are generally deductible by the

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[76]Commissioner v. Ickelheimer, 132 F.2d 660, 662 (2d Cir. 1943) (L. Hand, J., dissenting). Interestingly, Hand contrasted the vague meaning of words to the "fixed" meaning of scientific symbols. Several courts have held figures in a statute to represent different numbers than they appear to represent. *See, e.g.*, Wesley v. Bd. of Educ., 403 S.W.2d 28 (Ky. 1966); Kiley v. Kennedy, 16 Misc.2d 969 (Sup.Ct.), 190 N.Y.S.2d 53 (1958).

[77]Harrison v. Northern Trust Co., 317 U.S. 476, 479 (1943).

[78]Legislative intent should be found by looking at the objective manifestations of that body. This parallels the method courts use to ascertain the meaning of contract terms. 4 WILLISTON ON CONTRACTS § 600A (3d ed. 1961).

> Such objective manifestations of congressional intent can be found in the committee reports. For generations the sheer bulk of legislative business has been deemed to make it necessary for each house of Congress to delegate to committees the major part of its day-to-day work in determining what laws are needed and what form they should take. Every bill . . . immediately after introduction, is therefore referred to a committee, and the house normally takes no action on the measure unless and until the committee reports favorably thereon. The primary function of the committee report is . . . to appraise that body of the substance of the committee's recommendations and its reasons therefor. To the extent that the house passes the provisions as recommended by the committee, it is considered to have adopted as its own the views stated in the report.

G. FOLSOM, LEGISLATIVE HISTORY 28 (1972). The Supreme Court has repeatedly used committee reports as evidence of congressional intent. *See* Zuber v. Allen, 396 U.S. 168 (1969); Mastro Plastics Corp. v. NLRB, 350 U.S. 270, 287-88 (1956).

[79]*See* text accompanying notes 11 and 12 *supra*. *Compare* Swank & Son, Inc. v. United States, 362 F. Supp. 897, 898 (D. Mont. 1973) *aff'd* 522 F.2d 981 (9th Cir. 1975) (noting that the committee reports evince a congressional purpose to distinguish between active and passive corporations) *with* Zychinski v. Commissioner, 506 F.2d 637 (8th Cir. 1974), *cert. denied* 421 U.S. 999 (1975) (stating that these committee reports do not support the proposition that active secutities dealers can elect subchapter S).

[80]*See* Church of the Holy Trinity v. United States, 143 U.S. 457, 463 (1892).

[81]Hewitt, *Some Intriguing Recent Developments in Subchapter S*, 44 TAXES 848, 859 (1966).

employer[82] in the current year and are not includable in the gross income of the employee until the year received.[83] The employee will usually be in a lower tax bracket after he has retired and these payments will accordingly be taxed at a lower rate. The advantage of subchapter S, in contrast to merely setting up these same plans in a regular corporate form, is the total elimination of the corporate tax. By imposing the passive income restraint, Congress attempted to preclude persons from receiving this additional tax deferral advantage without incurring any tax cost.

This is no reason to uphold a passive income limit today. The Tax Reform Act of 1969[84] imposed H.R. 10-type (self-employed retirement plans)[85] limitations on pensions paid to a shareholder-employee of a subchapter S corporation.[86] Now only fifteen percent of a shareholder-employee's[87] compensation, up to a maximum of $7500, can be contributed to a retirement plan and not be included in the employee's gross income for the current year.[88] Since these limits are the same as those imposed on the self-employed,[89] there can be no pension and profit-sharing tax advantage by incorporating personal investment activities.

The conclusion seems clear. Courts can restrict the literal meaning of a statute's words if that result would be in harmony with congressional intent. The legislative desire that income from operating firms should not be proscribed is found both in the committee reports and in the fact that this proscription will not remedy the evil of abuse of the corporate form, which has been dealt with in another section of the Code.

In *Marshall*,[90] the court held that a subchapter S election was terminated for a small loan company because more than twenty percent of its gross receipts was derived from interest. After upholding the Treasury regulations,[91] the court argued that all interest above the requisite percentage is fatal because the clear language of subsection 1372(e)(5) enumerates interest as a form of passive investment income per se.[92]

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[82] *See* I.R.C. § 404(a).
[83] *See* I.R.C. § 451(a).
[84] Pub. L. No. 91-172, 83 Stat. 487 (1969).
[85] I.R.C. § 404(e).
[86] I.R.C. § 1379.
[87] Any employee or officer of a subchapter S corporation who owns or is considered as owning within the meaning of § 318(a)(1), the family attribution rule, more than five percent of the outstanding stock of the corporation is a "shareholder-employee." I.R.C. § 1379(d).
[88] I.R.C. § 1379(b)(1).
[89] *See* I.R.C. § 404(e).
[90] Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975).
[91] The court concluded its analysis by noting that the Service's definition of "passive investment income" may well exclude some types of business operations from subchapter S treatment, but that there was nothing in the statute or its legislative history which would suggest that every corporation should, as a matter of right, be able to make the election under § 1372(a). Indeed, the court was of the opinion that the various requirements under §§ 1371 and 1372 indicate that not every corporation is entitled to the benefits of subchapter S. *Id.* at 263.

This conclusion begs the question. No one argues that every corporation can elect subchapter S, and it is the determination of these very "rights" and "requirements" which will disclose whether loan companies can make the election.
[92] *Id.* at 264.

The court assumed its conclusion. The assertion in a judicial opinion that a statute needs no interpretation because it is clear is in reality evidence that the court has already considered and construed the act.[93] Further, the conclusion does not appear to be warranted in light of the evidence indicating a congressional desire to allow active businesses to elect subchapter S.[94]

Arguing that the words of a statute should not be read alone, but in conjunction with the legislative purpose, the court in *House v. Commissioner*[95] held that interest earned by a small loan company should not preclude a subchapter S election. Specifically, the court noted that subsection 1372(e)(5) headings "Personal holding company income" and "Passive investment income" were deliberately employed by Congress to make clear its legislative purpose and therefore the word "interest" should not be read in isolation.[96] Without more analysis, the court then concluded that interest earned by small lending institutions fits neither the words "personal holding company income" nor the words "passive investment income," and thus such firms can elect this subchapter.[97] Therefore, construing the words "passive investment income" in harmony with the legislative intent leads to the conclusion originally espoused in *House* and later followed in *Puckett,* that finance companies should be allowed to elect subchapter S.

CONCLUSION

Treasury regulation 1.1372-4(b)(5) which excludes loan repayments from gross receipts should not be upheld because it discriminates in favor of firms with inventory, carves out an unwarranted exception from the meaning of

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[93]Radin, *Statutory Interpretation,* 43 HARV. L. REV. 863, 869 (1930). The commentators seem uniform in agreeing with this analysis. Extrinsic facts may show a contextual meaning which the words will fairly bear and which better accords with the statutory purpose. They may bring to light an ambiguity in language which was assumed to be clear and explicit. In such a case, extrinsic aids show that the meaning was never clear. If, as is often said, the phrase "plain and explicit meaning" indicates that it is the only meaning the words will bear, then it begs the question. All possibilities of the existence of other reasonable meanings are therefore cut off. de Sloovère, *Extrinsic Aids in the Interpretation of Statutes,* 88 U. PA. L. REV. 527, 553 (1940).

"Statements that the statute is clear and unambiguous in no way disclose the source from which or manner in which meaning is derived. Such statements are merely complicated explanations of the court's satisfaction with the result it reaches reading the statute as it reads it." Horack, *The Disintegration of Statutory Construction,* 24 IND. L.J. 335, 338 (1949).

The *coup de grace* may well have been given by Sutherland. Statements arguing that a statute is clear can hardly be taken at face value after opposing parties have gone to all the expense and trouble to litigate a question about the meaning of a statute and have carried the issue through several courts. 2A SUTHERLAND STATUTORY CONSTRUCTION § 45.02 (4th ed. 1972).

[94]*See* text accompanying notes 79-89 *supra.*

[95]453 F.2d 982, 987 (5th Cir. 1972).

[96]*Id. Accord,* Paul E. Puckett [1974] 43 T.C.M. (P-H) ¶ 74,235, *aff'd* 522 F.2d 1385 (5th Cir. 1975).

It should be noted that headings are part of the context of the statute and should be considered when interpreting the latter. *See* Knowlton v. Moore, 178 U.S. 41, 65 (1900); Carter v. Liquid Carbonic Pacific Corp., 97 F.2d 1, 4 (9th Cir. 1938).

[97]With just as little analysis, Kenneth W. Doehring, [1974] 43 T.C.M. (P-H) ¶ 74,234, *rev'd* 37 A.F.T.R.2d 76-396 (8th Cir. 1975), held that lending institutions did not qualify for subchapter S. The reversal by the Eighth Circuit was only for the pre-1966 years.

gross receipts, and is internally inconsistent. If subsection 1372(e)(5) is properly construed, financial firms should be able to treat loan repayments as other firms treat sales revenue, thereby passing the twenty percent test for passive income and qualifying for a subchapter S election. In addition, even if financial companies do not pass the percentage test, an election should be allowed because the word "interest" in the statute should be read in harmony with the words of the subsection's heading "Passive investment income" and thus comport with the congressional desire to allow active lending institutions to benefit from the advantages of subchapter S. For these reasons, financial corporations should be allowed to elect subchapter S.

JEFFREY K. RIFFER