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Charles C. Parlin
Wright, Gordon, Zachry & Parlin

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"DEFINITION AND CLASSIFICATION OF SECURITIES UNDER THE REVENUE ACTS"*

By CHARLES C. PARLIN

"Securities can take many forms, and it is hazardous to try to find molds into which all arrangements can certainly be poured."

This is the analysis by Judge Learned Hand in *Jewel Tea Company, Inc. v. U. S.*[1] Yet the Revenue Acts force the lawyer to classify instruments issued by corporations and important tax results depend on the classification. Generally speaking, instruments issued by corporations must be classified for tax purposes as (a) "stock", (b) "securities" or (c) "other property".

"STOCK"

The following opinion might some day be called for:

"Dear Sirs:

You have requested our opinion as to whether (a) the interest on the Company's Debentures and (b) the dividends paid upon its 6% Cumulative Preferred Stock, or either, may be deducted in computing taxable net income.

* Of the New York City Bar; member of firm of Wright, Gordon, Zachry & Parlin.

[1] 90 F. (2d) 451 (1937).

It has been stated that 'A certificate of indebtedness is * * * quite a different thing from a certificate of capital stock in a corporation' (*Armstrong v. Union Trust & Savings Bank,* 248 Fed. 268, C.C.A. 9th, 1918), and of course interest paid upon the former, only, may be deducted in computing a corporation's income subject to income tax.

In view of the provisions of the Company's issues of debentures and preferred stock and in view of the facts surrounding the issue thereof, as disclosed in the papers submitted to us, it is our opinion (a) that the debentures are in fact preferred stock (*In re Fechheimer Fishel Co.,* 212 Fed. 357, C.C.A. 2nd, 1914, cert. denied 234 U.S. 760), and (b) that the preferred stock in fact represents a debt (*Jones Syndicate v. Commissioner,* 23 F. (2d) 833, C.C.A. 7th, 1927; *Palmer, Stacy-Merrill, Inc. v. Commissioner* 37 B.T.A. 530, modified opinion 39 B.T.A. 636).

Therefore, the interest paid upon the debentures, being in fact dividends, is not deductible, but the dividends on the preferred stock, being in fact payments of interest, are deductible, in computing the net income of the corporation.

Very truly yours,"

As this unlikely, but nevertheless possible opinion indicates, whether an instrument represents stock or indebtedness is not always as clear as the court in the *Armstrong* case seemed to think.

There is no comprehensive rule which can be relied upon to decide this question, but the following characteristics and circumstances tend to distinguish a certificate of indebtedness and to differentiate it from a share of stock: (1) designation as a bond, debenture, note, or other generally accepted term for an indebtedness; (2) intention of the parties that the instrument represent a debt rather than a stock interest; (3) fixed rate of interest; (4) absence of voting powers; (5) parity with general creditors as to interest and principal; (6) provision for payment irrespective of net profits; and (7) maturity date.

It is clear that any instrument containing all of the above provisions constitutes an indebtedness with respect to which payments of interest are deductible for income tax purposes.[2] It is also clear, however, that an instrument may constitute an

2 Old Colony R. R. v. Commissioner, 284 U. S. 552.

indebtedness although it does not contain all of the above provisions.

At the present time the corporate income tax is effected by the classification as interest or dividend. If Congress adopts a "war excess profits tax" in any one of the various forms from time to time discussed in the press, the problem will become even more acute in the computation of the "invested capital" and in the computation of "pre-war earnings". In any classification the following factors, at least, must be considered:

DESIGNATION

Designation of a corporate instrument, while perhaps not immaterial, is certainly not conclusive. In the *Jewel Tea Co.* case, *supra,* the taxpayer was attempting to get the benefit of a deduction for premiums paid on the redemption of its preferred shares, the argument being that because of certain charter provisions the shares were the equivalent of debt. The court denied the deduction but in discussing the problem said:

"the test cannot be merely the name given to the security."

and again the same court in denying a deduction for "interest" paid on "debentures" said:[3]

"The name is not conclusive of the nature of the securities."

In re Fechheimer Fishel Co., supra, is a bankruptcy case but the principle is clearly stated. The question at issue was the validity of a promissory note issued by the corporation in exchange for one of its outstanding "debenture bonds". The argument was made that these "debenture bonds" were in fact preferred stock and that the note was invalid because it had been given in retirement of stock. The court sustained the contention stating:

"It is necessary in the first place to determine the real nature of the so-called 'debenture bonds' which this corporation issued. The courts

[3] Commissioner v. Schmoll Fils Associated, Inc., (C. C. A. 2nd), F. (2d), March 18, 1940.

have determined that the fact that an instrument is called a 'bond' is not conclusive as to its character. It is necessary to disregard nomenclature and look to the substance of the thing itself."

The Board of Tax Appeals in *Proctor Shop, Inc. v. Commissioner*[4] had before it instruments called "debenture preference stock". The Board held that amounts paid on these instruments constituted interest and could be deducted as such in computing net income, stating:

"In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. On this the designation of the instrument issued by the corporation, while not to be ignored, is not conclusive."

INTENTION

Not only have the courts been willing to disregard the name of a corporate instrument and the terminology of the corporate records, but they have been surprisingly liberal in allowing oral testimony on the intention of the parties even though the same is in direct conflict with the written records. In the *Jones Syndicate* case[5] the group borrowed money to redeem real estate from foreclosure. The testimony showed that a lender was willing to put up the money at an interest rate of 14% but in order to circumvent the usury laws of Illinois the lawyers worked out for him a "first preferred stock". Under the terms these shares were subordinated to all debts and obligations of the syndicate; voting control passed to the holders of the shares if the same were not redeemed on or before a specified date. The Board allowed this and other oral evidence regarding the reasons and purposes and the intentions of the parties and found that the substance of the transaction was the creation of a debt and therefore allowed as an interest deduction the amount paid. The Court of Appeals affirmed, saying:

"We therefore conclude that a taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is compelled to execute a document which does not correctly describe the relation-

4 30 B. T. A. 721, affd. 82 F. (2d) 792.

5 Jones Syndicate v. Commissioner, (C. C. A. 7th), 23 F. (2d) 833.

ship of the parties, may, as against the government, disclose the true relationship of debtor and creditor. Sums by it paid as interest, regardless of the name by which it is called, may be deducted by the taxpayer from its income."

The Board of Tax Appeals again had before it payments on shares of "preferred stock"[6] on which the quarterly payments had been guaranteed and the company had also guaranteed that the shares would be redeemed at par in fixed numbers at specified dates. Again the Board allowed the taxpayer to introduce evidence showing the history of the transaction and the reason for the issue of the stock and the provisions regarding it and the Board was persuaded that the "dividend" payments were in fact interest and therefore deductible. The Board said:

"We regard the evidence of intent of the parties too clear to be overcome by formal recitations in the stock certificates."

In the *Bush-Moore Newspapers, Inc.* case[7] the taxpayer exchanged shares of its own "second preferred stock" for notes which it had outstanding and "guaranteed" the dividend payments. The Board again allowed the taxpayer to explain all of the surrounding circumstances and held that the "dividends" constituted interest because the parties intended to retain the creditor relationship in spite of the exchange of the notes for stock.[8]

Certainly the Board has been surprisingly lenient with the rules of evidence in allowing the parties full opportunity to present an oral version contrary to the written records. Yet it is not always persuaded. In the *Angelus Building & Investment Co.* case[9] and in the *Elko Lamoille Power Co.* case[10],

[6] Palmer, Stacy-Merrill Inc., 39 B. T. A. 636—previous hearing 37 B. T. A. 530.

[7] Bush-Moore Newspapers, Inc., 37 B. T. A. 787.

[8] See also Overland Knight Co., Inc., 15 B. T. A. 870; National Cotton Seed Products Corp. v. Comm., 76 F. (2d) 839 (C. C. A. 6th); Paramount Knitting Mills, 17 B. T. A. 91; Cf. Wiggins Terminals Inc. v. U. S. (C. C. A. 1) 36 F. (2d) 893.

[9] 20 B. T. A. 667, affirmed (C. C. A. 9th) 57 F. (2d) 130, cert. denied 286 U. S. 562.

[10] 21 B. T. A. 291, affirmed (C. C. A. 9th) 50 F. (2d) 595.

the Board listened to but ignored oral evidence attempting to prove that preferred stock had in fact been intended as a debt.

The New York courts have been less lenient with evidence on intent.

In *People ex rel Cohn & Co. v. Miller,* 180 N. Y. 16, the Court of Appeals of New York held that preferred debenture shares presented a "legal contradiction". The taxpayer, in the face of the declaration in the articles of association that the money represented by such certificates constituted a part of the capital stock of the corporation, was held to be estopped from asserting the contrary in a proceeding to determine their liability to the franchise tax. An element of estoppel was also suggested in the *Kentucky River Coal* case (*infra*), where the court noted that the debenture stock upon which an interest deduction was claimed had been treated as invested capital under the war excess profits tax.

Rate and Date of Payment

It is common for both preferred stock and instruments of indebtedness to provide for payment of dividends or interest at a fixed rate and at specified periodic intervals. While the cases often mention these factors they appear of little consequence in the ultimate determination of the nature of a particular instrument.

Voting Powers

Certificates of indebtedness ordinarily confer on the holder no voting power. But it is also common for preferred stock to confer no voting power upon the holder, except perhaps in the event of defaults or in the event of non-payment of dividends for a specified period. Many of the cases dealing with this subject mention the presence or absence of voting provisions in arriving at their ultimate conclusion but this factor has never been held vital. In the case of *In re Culbertson's,*[11] it was argued that the absence of a vote demonstrated that the instrument in question was debt and not

11 (C. C. A. 9th) 54 F. (2d) 753.

stock. The court apparently felt called upon to answer this argument and expressly stated that the absence of vote did not deprive the instrument of its character as preferred stock, making reference to the state law which specifically authorized the issuance of preferred stock with no voting power. A similar argument, made in the *Schmoll* case, *supra,* was tersely answered by the Circuit Court of Appeals for the Second Circuit with the statement:

"While the debenture holders have no vote at meetings of the company, preferred stockholders sometimes have no such right."

This matter seems elementary and yet it is often discussed in the cases.[12]

Relationship to General Creditors

The relationship to general creditors while not a determinative factor constitutes an important element in differentiation between debt and stock. The cases have gone both ways on this point. For example, in *Estate Planning Corporation v. Commissioner*,[13] the court had before it debentures which had been issued for the good will of a partnership and had been made specifically subordinate to the rights of creditors and yet these debentures were held to constitute debt.[14] On the other hand, in the *Fechheimer Fishel* case, *supra,* the court quoted the provisions subordinating the debentures to the claims of business creditors and apparently gave considerable weight to these provisions in holding debenture bonds to be preferred stock. In the *Schmoll* case (*supra*), the court says:

"The debentures closely resemble cumulative preferred stock * * * in being subordinate to bank creditors in the payment of principal even

12 See Kentucky River Coal Corp. v. Commissioner, 3 B. T. A. 644; Schmoll Fils ssociated, Inc., 39 B. T. A. 411 (reversed C. C. A. 2nd); Commissioner v. National Grange Mutual Liability Co. (C. C. A. 1st) 80 F. (2d) 316.

13 101 F. (2d) 15 (C. C. A. 2nd, 1939).

14 An instrument may be debt even though subordinated to claims of ordinary creditors. The Proctor Shop, Incorporated v. Commissioner, 30 B. T. A. 721 (1934); Commissioner v. O. P. P. Holding Corporation, 76 F. (2d) 11 (C. C. A. 2nd, 1935) (affirming 30 B. T. A. 337, 1934); I. Uterburg & Co., Inc. v. Commissioner, 2 B. T. A. 274 (1925); H. R. De Milt Co. v. Commissioner, 7 B. T. A. 7 (1927).

where there is a liquidation of the company. In short the debenture holders do not possess the ordinary right of creditors to obtain unconditional payment of their claims at some time. The position of the debenture holders is that of investors rather than creditors."

Provisions placing preferred stockholders for all practical purposes on a par with general creditors by express prohibition against creation of liens on the property of the corporation or incurring of indebtedness in excess of stated amounts have uniformly been held not to be sufficient to transform a stock interest into a debt. In the *Kentucky River Coal* case (*supra*), the majority opinion made no reference to the limitation on indebtedness in excess of $25,000 so long as the preferred stock was outstanding. The dissenting opinion argued that this limitation, when coupled with the preference over the common stock, accomplished practically the same result as a lien or a mortgage upon the property of the corporation. In the *William Cluff Co.* case[15] a preferred stock provision prohibited the corporation from placing a lien upon its property or creating any unsecured indebtedness maturing later than one year from the date of issue. The Board found that, with this provision, the preferred stockholders were "almost certain to have their stock redeemed" and yet it held that a debt was not created. In the *McCoy-Garten Realty Co.* case[16] the corporation agreed not to encumber its property or incur indebtedness over $2,000. The Board stated that this provision was

"more easily interpreted as protection to preferred stockholders than, as suggested by the petitioner, as showing that the preferred stockholders were, in fact, creditors." (p. 858)

Payment Irrespective of Net Profits

In the *Fechheimer Fishel Co.* case (*supra*), the Board in holding that debenture bonds were in reality preferred stock relied upon the facts that interest was payable only out of earnings, and that upon final distribution of the corporation's assets the so-called debenture bonds were entitled to the whole

15 7 B. T. A. 662 (1927).
16 14 B. T. A. 853 (1928).

residue of the company's assets after payment of its debts. The Board said:

"These features are quite characteristic of stock. They are not at all characteristic of bonds."

In *Commissioner v. O. P. P. Holding Corporation, supra,* the debenture bonds were subordinated to the claims of all other creditors and the company could at its option suspend or defer the payment of interest. The court said that these provisions were not fatal in view of the fact that ultimately the debenture holder was to be paid a definite sum at a fixed time, irrespective of the existence of net profits.

In the *H. R. De Milt Co.* case[17] the Board of Tax Appeals held, however, that where a corporation issued its 20-year debentures and common stock for the assets of a partnership, the debentures represented evidences of indebtedness rather than invested capital for the purposes of the war excess profits tax despite the fact that the interest upon the so-called debentures was payable only out of surplus or net profits. The Board said:

"Nor do we think the fact that the interest was to be paid out of 'surplus or net profits' would be controlling."

It is evident from the decisions and the dissents that the members of the Board are not in accord, among themselves, as to the weight to be accorded this factor. In *The Tennessee Company*[18] the Board held, Mellott and Kern dissenting, that interest-bearing income notes payable as to principal and interest only out of net earnings constituted indebtedness rather than shares of preferred stock under the personal holding company provisions of the Revenue Act of 1934, and that amounts paid in retirement thereof were deductible in computing the undistributed adjusted net income of the corporation. The majority said:

"The fact that both principal and interest of the notes were payable primarily out of net earnings and that the notes had no fixed due date

[17] 7 B. T. A. 7.

[18] 40 B. T. A. 154; aff'd. C. C. A. 3rd, March 29, 1940.

does not, in the light of their other attributes, destroy the character of the 'promissory notes' as evidences of indebtedness."

In the most recent case on this question, however, the Board was compelled to swing the other way because of the local law. In the *Dayton & Michigan Railroad Co.* case[20] the petitioner issued preferred stock having guaranteed dividends but no voting rights. A mortgage on the petitioner's property secured the payment of the dividends and it was provided that the properties of the company should not thereafter be encumbered to the prejudice of the preferred stockholders. In case of default the trustee under the mortgage was entitled to take over management of the railroad. The Supreme Court of Ohio had held that the shares were not debt for purpose of local tax despite the mortgage and its provisions because dividends were payable only out of earnings and the rights of the preferred stockholders were in other respects subordinate to those of creditors. Although the Board stated that it was not bound by the Ohio Court, it nevertheless followed the conclusion, emphasizing, as a reason for its decision, the fact that dividends were payable only out of earnings.

The difference of opinion among the members of the Board is further demonstrated in the majority and minority opinions in the *Schmoll* case (*supra*).[21]

Obligation to Pay Principal on Definite Maturity Date

A line of authorities make it clear that the existence of a positive obligation to pay on a definite maturity date, or the right of the holder of an instrument at his option to demand payment, is not in itself enough to make the instrument a debt.

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19 Cf. Haffenreffer Brewing Company, 41 B. T. A., February 20, 1940.

20 40 B. T. A. 856.

21 The Treasury Department is also uncertain of its position in this matter. In G. C. M. 10384 it was ruled that interest accrued on the "Income Debentures" of New York Railways Co. was deductible. While revocation of this ruling has not been published an assessment has been made and the general Counsel has stated his intention to litigate the point.

Thus, in *Perrine & Buckelew, Inc. v. Commissioner,*[22] certain assets had been set aside to liquidate the "A stock" of the corporation and 6% per year was payable upon their value. Despite the fact that the shareholder had the right to have his stock redeemed upon notice to the corporation, it was held that the security was stock and not a debt. In the *Kentucky River Coal* case, *supra,* the preferred stock in question provided for retirement in 10 years from the date of its issue and yet the court held that this was not sufficient to change its status from that of stock to indebtedness.[23]

On the other hand, in *Bolinger-Franklin Lumber Co. v. Commissioner,*[24] it was held that certain Class A preferred stock was in fact an indebtedness, apparently because of the provisions for its retirement. The stock had been issued for certain timber land and by its terms was redeemable out of the gross receipts from the sale of the timber by the corporation, the corporation guaranteeing, subject to certain contingencies beyond its control, to market a specified amount of the timber each year.[25]

But can an instrument constitute a debt if there is no ultimate due date for the principal?

The First Circuit has held in the affirmative, allowing deduction of interest paid to the holders of "guaranty units" without maturity date issued by a mutual insurance company.[26] The Fourth Circuit also will allow a deduction for interest payments made on instruments lacking maturity date.[27] The Board has consistently held that a due date for the principal was not an essential to the establishment of a debt relationship.

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[22] 32 B. T. A. 168.

[23] Similar provisions were involved and similar results reached in Leasehold Realty Co. v. Commissioner, 3 B. T. A. 1129 (1926); William Cluff Co. v. Commissioner, 7 B. T. A. 662 (1927); Doan Savings & Loan Co. v. Commissioner, 12 B. T. A. 772 (1928); McCoy-Garten Realty Co. v. Commissioner, 14 B. T. A. 853 (1928); Elko Lamoille Power Co. v. Commissioner, 21 B. T. A. 291 (1930); Finance & Investment Corp. v. Commissioner, 19 B. T. A. 643 (1930); In re Culbertson's, 54 F. (2d) 753 (C. C. A. 9th, 1932).

[24] 7 B. T. A. 402.

[25] See, also, Guaranty State Savings & Loan Co. v. Commissioner, 14 B. T. A. 72 (1928).

[26] National Grange Mutual Liability Co. v. Commissioner, 80 F. (2d) 316.

[27] Helvering v. Richmond F. & R. R. Co., 90 F. (2d) 971.

In the Second Circuit, however, it is doubtful whether a taxpayer can secure a deduction for interest paid unless the instrument contains a definite maturity date for the principal, in spite of the fact that the court has recently taken care to state that the precise issue was not passed upon. In *Commissioner v. O. P. P. Holding Corp.*[28] the court held that 25-year debenture bonds issued by the taxpayer constituted indebtedness and in reaching its conclusion laid stress upon the maturity date as proof of the debt relationship, saying:

"The final criterion between creditor and shareholder we believe to be the contingency of payment."

In *Jewel Tea Co., Inc. v. U. S., supra,* the court, in holding that preferred shares did not constitute indebtedness, stated:

"Possibly *Commissioner v. O. P. P. Holding Corporation, supra,* 76 F. (2d) 11, does not commit us to the doctrine that shares must under all circumstances be debts when they contain a provision that the holder may unconditionally demand his money at a fixed time. * * * All we now decide is that in the absence of such a provision the security cannot be a debt."

But in reversing the Board in the *Schmoll* case, *supra,* and holding that debentures without maturity date did not constitute debt the court, after reviewing the cases, said:

"It is not necessary to hold that the absence of a maturity date if taken alone would necessarily prevent a document from representing an 'indebtedness' as that word is used in Section 23 (b) of the Revenue Acts of 1932 and 1934 or would invariably preclude the return from investments evidenced by the debentures from being treated as 'interest'. But here the absence of a maturity date, the obligation to pay income from net earnings and the subordination of the debentures to the rights of bank creditors renders the payments more like dividends than interest and the securities like preferred stock rather than bonds."

It also seems doubtful whether the Fifth Circuit will allow a deduction for interest unless the instrument has a maturity date. In *U. S. v. South Georgia Railway Co.*[29] the court in reversing the lower court said:

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[28] 76 F. (2d) 11.
[29] 107 Fed. (2d) 3.

"There is, thus, an entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default."[30]

CONCLUSION

In summary on the issue of stock or debt, no exact definition is possible under the present cases. Corporations have experimented, and no doubt will continue to experiment, in devising instruments which will give the tax advantage of deductions for interest paid and yet retain for the corporation the advantages of preferred stock, namely discretionary current payment for the use of the funds invested in the enterprise and freedom from obligation to return the funds so invested. The cases involve factual matters to such a large degree that the courts have had, and will continue to have, difficulty in framing questions of law which can be put at rest by the Supreme Court. Meanwhile when a corporation wishes to issue instruments departing from the usual form of debt the lawyer will have to test them in the light of the various factors discussed herein and weigh the risks of losing the benefit of the deduction for interest paid against the corporate advantages sought to be obtained.

"SECURITIES" V. "OTHER PROPERTY"

In many instances under the Internal Revenue Code the identification of a corporate obligation as a security or not a security must be made. For example:

I. Section 112(b)(3) provides that no gain or loss shall be recognized if stock *or securities* in a corporation, a party to a reorganization, are, in pursuance of the plan of reorganization, exchanged for stock *or securities* in such corporation or in another corporation a party to the reorganization. The problem here may arise in identifying either the old obligations turned in by the taxpayer or the new obligations being issued to him in exchange.

[30] Cf. Thomas v. Perkins, et al, 108 F. (2d) 87 (C. C. A. 5th).

II. Section 112(b)(4) provides that no gain or loss shall be recognized if a corporation, a party to a reorganization, exchanges property, in pursuance of the plan of reorganization, for stock *or securities* in another corporation a party to the reorganization.

III. Section 112(b)(5) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons in exchange for stock *or securities* and immediately after the exchange such persons are in control of the corporation.

IV. Section 113(a)(5) singles out stock *or securities* of a foreign personal holding company from the general rule of cost basis for property transmitted by death and provides that the cost basis for such stock and *securities* shall be the fair market value at the time of acquisition or the basis in the hands of the decedent, whichever is lower.

V. Section 113(a)(6) provides the basis for allocating a substituted cost basis between the properties (other than money) received upon a tax-free or partially tax-free exchange. If the obligations received are not securities but "other property" an amount of cost base is assigned to them equivalent in amount to their fair market value at the date of the exchange; if the obligations are securities the original cost base will be allocated between the stock *and securities* received on the basis of their relative fair market values at the date of the exchange. This may, of course, be important. In the *Lloyd-Smith* case, for example, the question at issue was the cost basis on the sale of a $70,000 note which had been acquired by the taxpayer on the organization of a corporation, tax-free under Section 112(b)(5). If the note was not a security the cost basis was its fair market value at the time of receipt which was par, or $70,000; if it was a security a part of the cost basis of the properties transferred to the new corporation would be allocated to it and this allocation gave the note a cost of $438,032.70.

VI. Section 118 denies the benefit of a loss resulting from a wash sale of stock or *securities* and its counterpart, Section 113(a)(10) defines the cost basis for the stock or *securities*

which are acquired pursuant to such a transaction. These sections would not apply to corporate obligations which fell outside the definition of "securities."

VII. Section 332 defines personal holding company income as including (subsection b) gains from the sale or exchange of stock or *securities*. Apparently, gains from corporate obligations not meeting the definition would constitute non-personal holding company income in establishing the tax status of a foreign corporation.

VIII. Section 333(b) provides that in ascertaining whether a corporation is to be classed as a foreign personal holding company so far as stock ownership is concerned all *securities* convertible into stock shall be considered as outstanding stock. Apparently the rule does not apply to corporate obligations which are not within the scope of the definition.

The United States Supreme Court on January 2, 1940, held the transfer of all the properties of a Texas irrigation company not a "reorganization" under the Revenue Act.[31] The Government made the argument, among others, that the bonds, which had been issued in exchange and which matured serially over a period of 13½ months to approximately 12 years, did not constitute "securities." The Court brushed aside differentiations based on length of term and Mr. Justice Roberts said:

> "In applying our decision in the Pinellas case the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. There has naturally been some difficulty in classifying the securities involved in the various cases.
>
> We are of opinion that the term of the obligations is immaterial."

The Board of Tax Appeals is obviously confused on the issue. On February 14, 1940, in *Alabama Limestone Co. v. Commissioner*,[32] a bondholders committee had taken over all the properties of an insolvent corporation at bankruptcy sale

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31 Le Tulle v. Scofield, 60 Sup. Ct. 313.

32 41 B. T. A.

and organized a new company. The question was the cost basis of the properties and the Board, trying to apply the *LeTulle* case, held there was a reorganization and that the old basis carried over. VanFossan and Leech dissented without disclosing their reasons. Murdock wrote a dissent in which he analyzed the *LeTulle* case and came to the conclusion that there was not a reorganization and Sternhagen and Opper agreed with this dissent. Disney dissented on still another analysis. Mellott announced his dissent on the basis of the views expressed by both Murdock and Disney.

In retrospect it can now be seen that *Pinellas Ice & Cold Storage Co. v. Commissioner,*[33] was the source of this and at least two other lines of decisions, none of which have yet come to rest. The *Pinellas* case was fairly simple. The Company transferred all of its assets for $400,000 in cash and $1,000,000 in four months' notes. Mr. Justice McReynolds in holding that there had been no "reorganization" under these facts said, in the first place:

> "The mere purchase for money of the assets of one company by another is beyond the evident purpose of the provision."

This is the doctrine which, carried to its extreme conclusion, flowered in the *Gregory* case.[34] Certainly the Board of Tax Appeals and the courts have not to date found a satisfactory limit for the extension of this doctrine of "purpose" and a practitioner is always harassed with the problem that his transaction to be a "reorganization" within the definition of the statute must not only meet the terms of the statute but must meet a "purpose" intended by Congress.

Again, when Mr. Justice McReynolds said:

> "We think that to be within the exception the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short term purchase money notes."

he picked up a thought which had been previously expressed by Judge Augustus Hand in *Cortland Specialty Co. v. Com-*

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[33] 287 U. S. 462 (1933).

[34] Gregory v. Helvering, 293 U. S. 465.

missioner,[2] enlarged it, and started that turbulent stream of cases dealing with "continuity of interest."

And again, when Mr. Justice McReynolds said:

"These notes—mere evidence of obligation to pay the purchase-price —were not securities within the intendment of the Act and were properly regarded as the equivalent of cash. It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price receives well secured short term notes (all payable within four months) when another who makes a like sale and receives cash certainly would be taxed. We can discover no good basis in reason for the contrary view and its acceptance would make evasion of taxation very easy. In substance the petitioner sold for the equivalent of cash."

he started the courts and the Board of Tax Appeals off on a game of "blind man's buff" to find the definition of a security.

Apparently this last specific question—the definition of securities for purpose of the reorganization sections—attracted the attention of the Supreme Court only once in the period intervening between the *Pinellas* case and the *LeTulle* case. This was in *Helvering v. Watts*[35] where a corporation had disposed of all its assets in exchange for stock and what the Court described as "$1,161,184.50 of mortgage bonds." The record indicates that these in fact were bonds secured by a mortgage and were guaranteed by an affiliated company. $161,184.50 matured in two months and $1,000,000 matured serially over a period of seven years. Without discussing or disclosing in the opinion the nature of the instruments, Mr. Justice McReynolds merely stated:

"The bonds we think were securities within the definition and cannot be regarded as cash as were the short term notes referred to in *Pinellas Ice & Cold Storage Co. v. Commissioner.*"

With only the *Pinellas* and *Watts* cases as guides the courts have failed to find any precise definition but were tending

[35] 296 U. S. 387.

toward a proposition that the test was the term. A long term obligation was a "security"; a short term was not.

Each court began to look for the length of term necessary. The Circuit Court of Appeals for the First Circuit in the *Averill* case[36] thought that a $2,500,000 ten year bond issue maturing serially constituted "securities" under the *Watts* case (but rejected the Commissioner's claim that there was a reorganization on other grounds). The Second Circuit in the *Tyng* case[37] held that an $11,000,000 issue of 20-year convertible debentures of the Associated Gas & Electric Company were "securities" merely because of their long term, specifically rejecting the argument of the Commissioner that only secured obligations could be "securities." In the *Stirn* case[38] it held that $463,000 of debenture bonds maturing $100,000 in one year and the balance over another four years, but all in fact paid off within one year, were not "securities." As the reason Judge Augustus Hand stated:

> "In the case at bar the bonds not only had an average maturity of only two and a half years but were all paid off within ten months."

The Third Circuit in the *Freund* case[39] held $600,000 of six year first mortgage bonds to be "securities." The Seventh Circuit in the *Kitselman*[40] case thought some long term bonds were securities and in the *Burnham*[41] case that ten year promissory notes also were securities. The Ninth Circuit in the *Lilienthal*[42] case held ten year collateral trust bonds to be securities characterizing the Commissioner's argument to the contrary as "unsupported by authority and obviously unsound." The Board of Tax Appeals in the *Graham*[43] case held that debentures having a six and one-half year term yet

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36 Averill v. Commissioner, 101 Fed. (2d) 644 (1938).

37 Commissioner v. Tyng, 106 Fed. (2d) 55 (1939).

38 L. & C. Stirn, Inc. v. Commissioner, 107 Fed. (2d) 390 (1939).

39 Commissioner v. Freund, 98 Fed. (2d) 201 (1938).

40 Commissioner v. Kitselman, 89 Fed. (2d) 458 (1937).

41 Burnham v. Commissioner, 86 Fed. (2d) 776 (1936) cert. denied, 300 U. S. 683.

42 Lilienthal v. Commissioner, 80 Fed. (2d) 411 (1935).

43 Graham v. Commissioner, 37 B. T. A. 623 (1938).

to run which were assumed by the taxpayer were not securities but pointed out that the entire issue had been called and paid off within less than a year of the assumption date; in the *Segall*[44] case that a fifteen month promissory note was not a security but that secured debenture notes, guaranteed, maturing in installments at the end of one, two, three and four years, respectively, were securities; in the *Lloyd-Smith*[45] case that a two-year unsecured note was not a security.

On the question of term of the obligation, the above cases do not easily lend themselves to classification or rationalization. There is no case in which an obligation running six years or more (and not called before maturity) is denied classification as a security. On the other hand, the *Tyng* case held that obligations maturing serially over a period of one to five years were not securities, and the *Segall* case held that obligations maturing over a period of one to four years were securities. In the *Watts* case the obligations matured serially, the first series of $161,184.50 being for a term of 1½ months and the next series of $150,000 for a term of about 1 year and the next series of $150,000 for a term of about 2 years. Of the aggregate issue approximately 40% bore due dates of about two years or less and the average maturity date for the entire issue was 3 years and 3 months but the Supreme Court stated definitely that all of these instruments were "securities."

The Government may be in part responsible for the confusion because rather than attempt to establish a particular principle it has argued on both sides in order to protect the revenue in particular cases. For example, in order to defeat the establishment of a "reorganization," the Government has argued in various cases that promissory notes are not "securities," that short term notes are not "securities," that unsecured obligations are not "securities"; and yet in the *Burnham* case, in order to prove that there was a "reorganization," reversed its position and argued, successfully, that unsecured promissory notes were "securities." When, in this case, the

[44] Segall v. Commissioner, 38 B. T. A. 43 (1938).

[45] Lloyd-Smith v. Commissioner, 40 B. T. A. 214 (1939).

taxpayer filed a petition for certiorari to the Supreme Court alleging that there was conflict between the circuits, the Government filed a brief in opposition to the petition stating at page 6:

"The term 'securities' when used without qualification or restriction as in the statute here involved includes promissory notes—both in popular speech and in law."

In this brief the Government also went on to make its distinction of the *Pinellas* case as follows:

"That case does not hold, as contended by petitioner * * * that promissory notes are not 'securities' within the provisions of the section of the statute here in question. It merely holds that those notes were *purchase money notes* and not 'securities' received *in exchange* for property."

In the *Lloyd-Smith* case the Commissioner argued that a $70,000 unsecured two-year note was not a security; in the *Huey & Philip Hardware* case[46] that a $70,000 unsecured demand note was a security.

The foregoing discussion refers primarily to cases which, in the text of the opinion, deal specifically with term. A large number of the "reorganization" cases involve the question of what constitutes a "security" but this particular point is often submerged or lost in the general discussion of whether there was a reorganization within the intent of the statute, the intention to effect a reorganization or a sale, the continuity of interest, whether the obligations were an important or incidental part of the transaction and whether the consideration accompanying the obligations in question was cash or stock.

The problem of determining what is and what is not a security remains and the Supreme Court in the *LeTulle* case has made a contribution of only a negative character—i.e., of the factors to be considered, the term of the obligation is immaterial.

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[46] 40 B. T. A. 780.

The Code itself gives no definition of a security applicable to the above sections, although the word is defined several times for limited and special purposes.[47]

Section 1800 of the Code levies a documentary stamp tax on all

"bonds, debentures or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities."

In *Mortgage Guaranty Co. v. Welsh,*[48] referring to this section, the court said:

"At the time of the enactment of this legislation the word 'securities' was defined in Cyc as 'written assurances for the return or payment of money; evidence of indebtedness.' 35 Cyc 1283."

This principle is equally applicable to the word "securities" as used in the reorganization sections and would tend to indicate a broad rather than a narrow construction of the term.

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[47] In Section 23(g) where losses on worthless securities are subjected to the limitations applicable to losses on the sale of capital assets, the word is defined as follows:

"(3) *Definition of securities.*—As used in this subsection the term 'securities' means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares."

In Section 23(k) dealing with the writing off of bad debts and securities, the word is defined:

"(3) *Definition of securities.*—As used in this subsection the term 'securities' means bonds, debentures, notes, or certificates, or other evidences, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form."

In Section 112(b)(5) it is provided that for the purpose of determining whether the control is in the proportion required by the paragraph the amount of any liabilities assumed by a transferor "shall be considered as stock or securities received by such transferor." In Section 115(h), dealing with the effect on earnings and profits of distributions of stock and securities, a sentence provides:

"As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities."

[48] (C. C. A. 9th) 38 F. (2d) 184. Mortgage participation certificates held to be securities.

There being no applicable definition in the Code, the courts will be forced to turn to other sources.[49] Webster's New International Dictionary defines the term "security" as

"An evidence of debt or of property as a bond, stock certificate, or other instrument, etc."

The Securities Act of 1933, as amended, provides, Section 2(1):

"The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness * * * or, in general, any interest or instrument commonly known as a 'security' * * *."

Again, these definitions tend to indicate a broad rather than a narrow construction of the term.

The *LeTulle* case has merely started the Board and the courts off anew on the search for a definition and there are few guides to date. Will not the ultimate answer be that an obligation issued by a corporation is a "security" if it represents a substantial interest and an investment position in the issuing corporation; it is not a security if it represents only a promise which is essentially equivalent to cash or a delayed payment? This would follow in a general way the philosophy of the "continuity of interest" rule which has become a basis for decisions in reorganization cases. It would also follow in a general way the reorganization cases which emphasize the purpose and intent of the transaction.

Under such a rule the term of the obligations, whether they were secured or unsecured, the size of the issue in relationship to the size of the corporation, the quick asset position of the corporation in relationship to the issue, and the purpose of the issue would all be factors which could be considered by the court.

For example, a $100,000 two-year promissory note of the United States Steel Corporation certainly would not be a security today under the cases. It would represent merely a deferred payment of money or "the equivalent of cash."

49 Greenville Textile Supply Co., 1 B. T. A. 152.

On the other hand, a $100,000 two-year promissory note of a corporation with only $150,000 of non-liquid assets would represent a substantial and important interest in that company. Such a note in a very real sense would constitute an investment in the enterprise rather than "the equivalent of cash" or a delayed payment.

It seems doubtful whether the courts can or will attempt to differentiate corporate obligations on the basis of their form—whether typewritten, on printed forms or engraved—or whether they have serial numbers or printed indentures behind them. While the courts tend to emphasize form in stamp tax cases, in income tax cases the trend is clearly to look at the substance of transactions, and ignore formalistic matters.

If this paper can conclude with a prophecy, it would be that the rule which will ultimately prevail as the test is this: Corporate obligations, in negotiable form and available for transfer, are securities if they give the holders a substantial interest in the affairs of the obligor company. Going back again to the *Pinellas* case, chief source of this general problem, there is ample authority for such a rule. The court there said, with reference to the utility company notes:

> "Certainly, we think to be within the exemption, the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase money notes."