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CORPORATE DEBT FINANCING UNDER THE TAX LAW

I—Introduction

The number of sole proprietorships and partnerships that are taking on the corporate form is steadily increasing. One of the reasons for incorporating is the tax savings available to corporations under the Federal Income Tax laws. However many corporations overlook the tax savings available to them through proper financing, namely debt financing. Other corporations, while not overlooking the use of debentures in financing, are unaware of the fatal tax consequences that can result from the improper use of debentures. The attorney called upon to advise a business about to incorporate should be aware of the advantages and pitfalls of debt financing so that he may make available to it tax savings that will not be later disallowed by the tax commissioner. This paper attempts to point out the advantages of debt financing, and how to avoid the pitfalls which may result in loss of tax savings.

II—The Advantages of Debentures

Since interest is deductible while dividends are not, there is an obvious tax incentive to having a corporation issue evidences of indebtedness as well as stock for the cash or property transferred to it by its stockholders. In addition, certain personal tax advantages will accrue to the organizers of the corporation, if they become creditors as well as stockholders of the corporation. If the corporation prospers, it may pay off its debt and the creditor-stockholders will realize income only to the extent that the payment exceeds the adjusted basis of the instruments paid off. The income, if any, will be capital gain under Section 1232 of the Internal Revenue Code. If the organizers hold only stock, however, the entire amount of any payment by the corporation, including a pro rata reacquisition of stock, would probably be taxed as a dividend, i.e., as ordinary income. On the other hand, if the corporation should fail, the creditor-stockholder has at least a fighting chance to write off his loss on the worthless debt against ordinary income. Such a deduction will be permissible if Sections 166 (d) and (e) are not applicable, i.e., if the debt is not evidenced by a "security" and if it is not a "nonbusiness bad debt". Loss on worthless stock, however, must be treated as a capital loss, Section 165 (g), unless Section 165 (g) (3) is applicable.

Because of these advantages many corporations are financed with a greater portion of securities than stock. Or a corporation may even be organized so as to fall without the nonrecognition rule of Section 351 in order that it may issue interest bearing instruments other than securities or so it may acquire a stepped-up basis on transferred property that has increased in value above its adjusted basis. Whenever a closely held corporation is financed in such a manner by its share-

holders there seems to arise a suspicion that the corporation and its shareholders are not entitled to these advantages.

An excellent example of the tax advantages of debt financing[1] is contained in the Harvard Law Review.[2] In brief the example presented is the incorporation of a business with a net worth of $300,000 and $400,000 worth of gross assets, which is netting $50,000 yearly after a reasonable allowance for owners' services. On incorporation it is determined that the corporation needs $300,000 in gross assets to operate. So at this point the corporation is "thinned". $100,000 is withheld in cash, reducing net worth to $200,000. The remaining $200,000 net worth is divided into $150,000 worth of 15 year 6% bonds and $50,000 capital stock. Assuming the corporation continues to net $50,000 annually, in about 7-8 years the corporation will realize approximately $250,000 after taxes. Assuming assets and liabilities to have remained about the same this $250,000 will be reflected by an increase in cash. Now the corporation can redeem the $150,000 of outstanding bonds and leave the remaining $100,000 in the corporation. This places the business in substantially the same position as before incorporation and before the $100,000 was withheld upon incorporation. As a result of these events the stockholders have withdrawn from the business $250,000 entirely free from income taxes to themselves, and the corporation may have postponed tax on accumulated earnings.[3] On the other hand a "thick" corporation capitalized at $300,000 would have to have netted an income of $1,665,000 as compared to the $400,000 required by the "thin" corporation to net its stockholders $250,000 in-pocket after taxes and maintain its net worth at $300,000.[4] The credit[5] and exclusion[6] provisions for stock dividends hardly offsets these advantages obtained by the issuance of debentures. The remainder of this paper shall concern itself with the treatment which the tax collector and the courts give to "debt" financing in closely held corporations, and what criteria these debt instruments must meet for tax recognition purposes.

III—NECESSARY ELEMENTS OF A DEBENTURE

Whether a business is incorporated under a tax free exchange[7] or under a taxable exchange, it always seems desirous to obtain the advantages of issuing

1. The term "debt financing" refers to the financing of a corporation with more debt than equity. "Thin incorporation" has the same meaning, but it seems wise to avoid its use in some contexts, since it suggests a ressult rather than a means. The result being that it is bad for tax purposes.
2. Schlesinger, *Thin Incorporation: Income Tax Advantages and Pitfalls*, 61 HARV. L. REV. 50 (1947).
3. INT. REV. CODE OF 1954, §531.
4. The example is more fully explained in 61 HARV. L. REV. 50 (1947).
5. INT. REV. CODE OF 1954, §34.
6. INT. REV. CODE OF 1954, §116.
7. Internal Revenue Code of 1954, Section 351 allows a business to be incorporated without recognition of taxable gain if certain criterion are met.

debt instruments. But a small closely held corporation may find it difficult to attract outside creditors, or may for economic or control reasons prefer not to be indebted to outsiders. Then it must turn to its own shareholders. At this point many queries arise: Will these debt instruments be recognized for tax purposes? What will the tax collector be looking for when the corporate financial structure is examined? What factors might lead to the nonrecognition of the debt intruments?

The answer to these questions lies in one word—"intent". The courts all say that they determine the validity of debt instruments by the intention of the parties; whether there was an intention to create a debtor-creditor relationship or to make a capital contribution. By breaking down the decisions we find that this intent is determined by one or a combination of three factors: (1) The form of the instrument, (2) The ratio of the debt to the equity financing, (3) Whether there is an intention to assume risks or to create a debt.

III—A. Proper Form

The court always seems to look to the form of an instrument first, for if it is not in form a bona fide indebtedness the court will conclude that a debt was not intended and the tax advantages will be disallowed. Indebtednesses lacking proper form are more commonly referred to as "hybrid" securities. They are issued usually because of fear of clogging the corporation's credit position, hoping that the instruments will pass as preferred stock before the creditors, and as a bond, debenture, or note before the tax collector. The case of *John Kelly Co. v. Commissioner*[8] is the leading case developing the use of the "hybrid" securities test. This case suggested the following characteristic of hybrid securities: (1) They are transferable only with stock, (2) They have far-off maturities or no maturity dates, (3) The "interest" is geared to income or is discretionary with the directors, (4) Payment of "interest" or "principal" or both, is subordinated to general creditors, and (5) They are issued only to stockholders and not for new consideration. Other cases have endorsed these characteristics of a hybrid security and have added others: (6) Repayment of the principal is uncertain or contingent,[9] (7) Lack of a definite obligation to pay a fixed sum,[10] (8) Lack of a method or the right to enforce payment in event of default,[11] (9) The name given the instru-

8. 326 U.S. 521 (1946).

9. Charles A. Polizzi, 16 T.C.M. 668 (1957); Wachmont v. Herdricksen, 137 F.2d 306 (9th Cir. 1943); Commissioner v. Page Oil Co., 129 F.2d 748 (2d Cir. 1942).

10. Charles A. Polizzi, note 9 *supra;* Staked Plains Trust v. Commissioner, 143 F.2d 421 (5th Cir. 1944).

11. Universal Oil Products Co. v. Campbell, 181 F.2d 451 (7th Cir. 1950); Commissioner v. Schnoll Fils Association, 110 F.2d 611 (2d Cir. 1940).

ment connotes a capital investment,[12] (10) Presence of an implied or express intent that payments are not to be indebtedness.[13]

If too many of these factors are found the instrument will be treated as preferred stock rather than as evidence of indebtedness. Some of these characteristics are more decisive. The lack of a fixed maturity date or the lack of a definite obligation to pay the interest or principal are enough in themselves to convert an indebtedness into stock.[14] On the other hand interest has been held to be deductible on instruments labeled and referred to as stock where there has been a fixed maturity date or redemption date.[15] This further emphasizes the fact that the substance of an instrument prevails over its form. In the case of *Max Greenhouse v. Commissioner*[16] the corporation there involved was financed entirely by loans, but there was no issuance of any instruments, nor any arrangements for the payment of interest or principal. The court dismissed taxpayer's argument that losses from these losses were business bad debts, and held them to be capital losses, treating the loans as contributions to capital. The court said that if the taxpayer intended to make a loan he should have fixed a maturity date and established a right to force payment in default.[17]

It seems quite clear that once an instrument comes under the scrutiny of the court it must meet the strict standards of a bona fide instrument of indebtedness or else be subject to being treated as a stock investment. The criteria used for hybrid securities are the same in the tax courts and in the higher courts, and all seem to apply these criteria with the same amount of strictness.

III—B. Unexcessive Ratio to Equity

The second factor in measuring the validity of debt instruments is the amount of the investor's holdings in debentures and in equities. Where the ratio of debt to equity has been too high many cases have resulted in refusal to recognize the indebtedness. Assuming that the corporation is so unconcerned about its credit standing that it can issue debt securities containing iron-clad indicia of debt, the court's problem is then whether the corporation is so undercapitalized so as to regard holders of indebtedness as stockholders or potential stockholders. If the court finds that advances are made to a newly formed corporation under the guise

12. Kingsmill Corp., 28 T.C. No. 33 (1957).
13. Pacific Southwest Ry. v. Commissioner, 128 F.2d 815 (9th Cir. 1942).
14. United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); A. R. Jones Syndicate v. Commissioner, 23 F.2d 833 (7th Cir. 1927); Universal Oil Products Co. v. Campbell, note 11 *supra;* 241 Corp., N.Y., N.Y., 15 T.C.M. 901 (1956).
15. Commissioner v. Palmer, Stacy-Merrill Inc., 111 F.2d 809 (9th Cir. 1940); A. R. Jones Syndicate v. Commissioner, note 14 *supra.*
16. 13 T.C.M. 849 (1954).
17. See also, 241 Corp., N.Y., N.Y., note 14 *supra.*

of debts where there is little or no paid-in capital, the advances will be treated as capital investments or contributions in their entirety.[18] The debt to equity ratio of 4:1 has generally been accepted by most courts as indicative of the fact that the corporation is not undercapitalized,[19] while a ratio in excess of 4:1 has been indicative of undercapitalization.[20] This ratio may not be realistic in some businesses,[21] e.g., corporations owning and operating real property—since creditors might be less concerned about low equity as long as value of underlying assets safely covers the amount of the creditors' loans. No case however has taken the view that the ratio test is to be considered in the economic context of the particular industry involved. This is probably because such a flexible use would present many administrative problems.

Both the tax court and the higher courts seem to accept and use the 4:1 debt-equity ratio. But the rigidity of the ratio has been tempered by the courts' accepting and using sound accounting concepts. In computing the equity investment such factors as unrealized appreciation, earned surplus, goodwill and other intangible assets are taken into consideration.

In computing the equity investment, the fair market value of assets contributed, rather than their book value, is the significant factor.[22] Most of the cases so holding concerned the tax free incorporation, pursuant to Section 351, of an already operating sole proprietorship or partnership.[23] Under these circumstances, assets in the hands of a transferee corporation take the basis of these assets in the hands of the predecessor sole proprietorship or partnership. Nevertheless, where such an exchange has been made, the courts, in determining the adequacy of capitalization, will look to the book value rather than the fair market value of assets in the hands of the corporate transferee. Even though the transfer of the appreciated assets, on incorporation, is to a completely new and never before functioning enterprise, it would appear that any demonstrable spread between the economic value and the book value of the transferred assets likewise should be included in computing the equity investment in the newly organized corporation.[24]

Earned surplus existing at the time of the issuance of notes or debentures is

18. Hilbert Bair, 16 T.C. 90 (1951), *aff'd*, 199 F.2d 589 (2d Cir. 1952); Erard A. Matthussen, 16 T.C. 781 (1951), *aff'd*, 194 F.2d 659 (2d Cir. 1952); Joseph B. Thomas, 2 T.C. 193 (1943).
19. Isidor Dobkin, 15 T.C. 31 (1950), *aff'd*, 192 F.2d 392 (2 Cir. 1951); Ainslie Perrault, 25 T.C. 439 (1955); Warren Brown, 27 T.C. 27 (1956).
20. Isidor Dobkin, note 19 *supra;* 241 Corp., N.Y., N.Y., note 14 *supra.*
21. Isidor Dobkin, note 19 *supra;* Kipsborough Realty Corp., 10 T.C.M. 932 (1951); Bacon Inc., 4 T.C. 1107 (1945).
22. Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); Ainslie Perrault, note 19 *supra.*
23. Sheldon Tauber, 24 T.C. 179 (1955); Cleveland Adolph Mayer Realty Corp., 6 T.C. 730 (1946).
24. United States v. W. J. Jones & Sons, Inc., 200 F.2d 846 (9th Cir. 1952).

similarly to be included in computing the equity side of the ratio.[25] As surplus accounts will be part of a corporation's underlying assets, to which creditors will look for satisfaction of their claims, this approach is sound from an accounting and economic standpoint.

Goodwill may be defined as the value attached to a business over and above the value attributed to the other stated assets. The basic element of goodwill is the probability that customers of a business will continue to patronize it. While, in general, only purchased goodwill is recognized by accountants for balance-sheet purposes, the existence of goodwill would be of significance to a lender. In several cases involving the adequacy of capitalization, existing goodwill, or going-concern value has been at least a make-weight in holding a corporation not to be thinly incorporated.[26]

The value of franchises, licenses, and similar intangibles are also to be included in the determination of capital.[27] To a lender relying on underlying assets, these are assets of consequence.

Thus, in the application of the ratio test, the cases, at least in these four areas have indicated an awareness of business and accounting realities.

Usually an excessive debt-equity ratio in addition to other equity indicia causes the court to hold a debt instrument to be equity, e.g., "hybrid" features,[28] intent to assume equity risks.[29] But debt instruments which have otherwise iron-clad indicia of debt have on occasion been held to be equity on the sole basis that the debt-equity ratio was excessive.[30] This use of the excessive debt-equity ratio as the sole criteria to determine the intent of the parties has been subject to recent criticism. *Rowan v. United States*[31] proclaims that if there is no manifestation of intent to create an equity rather than a debt other than the debt-equity ratio then a debt instrument should not be changed to capital. The court said in part . . . "It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established as a matter of hindsight, a ratio of stockholder owned debt

25. B. M. C. Manufacturing Corp., 11 T.C.M. 376 (1952); New England Lime Co., 13 T.C. 799 (1949), *acq.*
26. Bakhaus & Burke, Inc., 14 T.C.M. 919 (1955); Ruspyn Corp., 18 T.C. 769 (1952), *acq.*
27. John W. Walker, Inc., 23 T.C. 550 (1954).
28. 241 Corp., N.Y., N.Y., note 14 *supra;* Powers Photo Engraving Co. v. Commissioner, 197 F.2d 704 (2d Cir. 1952); Colony Inc. 26 T.C. 30 (1956); Charles A. Polizzi, note 9 *supra.*
29. Emanuel Kolkery, 27 T.C. 37 (1956); United States v. W. J. Jones & Sons, Inc., note 24 *supra.*
30. Isidor Dobkin, note 19 *supra;* Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955).
31. 219 F.2d 51 (5th Cir. 1955).

to the capital of the debtor corporation. ... Stockholders should be free to commit to corporations such capital as they choose and to lend such additional amounts as they may elect if that is their *true* intent. ... It is for Congress not the courts to establish a ratio if it is deemed necessary within the scheme of taxation."

This view was also suggested by the earlier cases of *Sam Schnitzer v. Commissioner*[32] and *Gussow, Kahn & Co. Inc. v. Commissioner*.[33] The *Rowan* case though disapproving the debt-equity ratio as a manifestation of intent did indicate what factors would determine that a debt instrument was really an equity. These factors encompass the accepted "hybrid" criteria, and add another criterion: If evidences of indebtedness were exchanged for assets or money necessary to commence the corporate life they will not be recognized as debt. The *Rowan* case, if followed, would not cause a great change in the intent criteria, since there are only a few cases that use the debt-equity ratio as the sole criterion in determining whether a debt or an equity was intended.[34] However the *Rowan* case could relax the 4:1 debt-equity ratio requirement. Corporate financial structures which have a debt-equity ratio in excess of 4:1 would be acceptable as long as the other factors indicative of equity are not present. Such an approach would thus answer the objection that the 4:1 ratio is not realistic because it does not take into consideration the economic context of the particular business involved. Under the *Rowan* approach the economic context could be taken into consideration.

III—C. Intent to Create a Debt

The third factor in determining the intent of the parties is whether or not the holders of the debt instruments meant to assume the risks of the business rather than to create a debt. (Although this phrase may also be descriptive of the former two factors, it is meant to encompass only that area where the debt instruments are not objectionable because of form or because of the debt-equity ratio.) Under this heading the courts look for two criteria: (1) Whether the stockholders' interests are identical with their interests as creditors. (2) Whether the debt instruments were issued to stockholders in exchange for assets required to get the business underway.

(1) *Identity of interests:* The cases holding that indebtedness is to be considered equity in a closely held corporation where the advances are made in substantially the same proportion as the stockholdings, usually use that factor in corroboration with an excessive debt-equity ratio.[35] The case of *Gooding Amuse-*

32. 13 T.C. 43 (1949).
33. 13 T.C. 580 (1949); 5 Tax Law Rev. 424 (1950).
34. Note 30, *supra.*
35. New England Lime Co., 13 T.C. 799 (1949), *acq.;* United States v. W. J. Jones & Sons, Inc., note 24 *supra.*

ment Co. Inc. v. Commissioner[36] in effect seems to hold that the receipt of stock and debentures in the same proportion by the incorporators as the interests transferred by them to the corporation is alone sufficient reason for the court to convert the debentures into capital. In this case a family partnership, consisting of three members, incorporated the partnership business. The incorporation was effected outside of the provisions of Section 351, and therefore was a taxable exchange. The assets of the partnership were sold to the corporation in exchange for no par common stock and interest bearing notes. The partners received stock and notes in the same proportion as their respective partnership interests. The notes were ordinary negotiable notes having none of the fatal indicia of hybrid securities, nor was there an excessive debt-equity ratio. But the court held that the notes were the same as stock, and therefore the interest payments were not deductible by the corporation and the principal repayments were taxable dividends to the stockholders. The court also held the original incorporation was tax free, and therefore the basis of the assets in the hands of the corporation was the same as in the hands of the partners. This result denied the corporation a sizable depreciation on those assets.

The decision was based upon the following reasons: First, the court stated—"The most significant aspect of the instant case is the complete identity of interest between and among the three noteholders, coupled with their control of the corporation. . . . It is, in our opinion, unreasonable to ascribe to the petitioner an intent at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution." Second, the court stated that as corroboration of its finding, the majority of the notes had long since reached maturity and had not been paid. But if we bear in mind that this is only corroboration of the basic premise that there was no intent to enforce the notes, then even without these corroborating facts the court could have come to the same conclusion. Thirdly, the court added that although there is nothing wrong with a transaction designed to produce the least tax, tax avoidance will not be permitted if the transaction on which such avoidance rests is a sham or lacks genuineness. In support of this the court offered the statement that "substance shall prevail over form"; but this statement is a conclusion to be based on legal rationale, and does not establish very much basis from which to draw a conclusion.

It has been suggested that under the court's reasoning it would be virtually impossible for any closed corporation to issue bonds or notes to its shareholders whether at the time of incorporation or subsequent to its incorporation. Also that the effect of such reasoning will upset the established theory of limitation of

36. 23 T.C. 408 (1954), *aff'd,* 236 F.2d 159 (6th Cir. 1956).

liability as being one of the prime considerations influencing individuals to incorporate.[37]

If the *Gooding* decision is followed then in spite of the presence of bona fide debts which do not violate the debt-equity ratio the courts may still strike down debentures and treat them as equity. The court need only find a complete identity of interests. On the other hand the *Gooding* case could be limited to its facts. It should be noted that the corporation consisted of a closed family corporation, and that the court held that there was not valid business purpose or reason for the transaction. In the cases of *Estate of H. B. Miller v. Commissioner*[38] and *Warren Brown v. Commissioner*[39] similar fact situations were presented: partnerships transferring assets to a corporation in exchange for stock and notes, and the stocks and notes being held in substantially the same proportion as the interests transferred. The court in those cases did not consider the identity of interests and upheld the notes as valid indebtedness in both cases. It is noted that the corporations in these latter two cases, though closely held, were not closed family corporations, and that the court in each case made a point of showing that there was a valid business purpose behind the exchange of assets for notes. However the business purposes in these cases are not so distinctive from those in the *Gooding* case so as to be the decisive factor. In the case of *Kraft Foods Co. v. Commissioner*[40] the Court of Appeals reversed the tax court's finding that notes were capital because there was no valid business purpose. The court said if the transactions are real they cannot be characterized as sham merely because they were entered into for the purpose of reducing taxes.

One might conclude that the court is more suspicious of closed family corporations than of closely held non-family corporations, and that it is easier to find complete identity of interest to strike down debentures in a family corporation than in a non-family corporation. Even if the court is correct in its suspicions, suspicion is hardly an adequate measuring stick of intention.

(2) *The purpose behind issuing debentures:* Until recently it was ordinarily assumed that if a new corporation issued bonds and stock to its organizers in exchange for business assets, the debentures (if valid on their face and not excessive in amount) would be recognized as such even though they were issued for fixed assets or other property necessary to conduct the business. The situation usually arises when a going business incorporates and sells its assets to the corporation in exchange for negotiable notes. The purpose of this is to lay the basis for interest deductions by the corporation as well as for withdrawals of corporate

37. A very good presentation and analysis of the *Gooding* case appears in: Robin, *The Clifford Case of the Thin Corporation*, 34 TAXES 282 (1956).
38. 239 F.2d 729 (9th Cir. 1956).
39. 27 T.C. 27 (1956).
40. 232 F.2d 118 (2d Cir. 1956).

profits in the form of payments on the purchase price of the assets. If the stock and notes had been issued in exchange for assets in a Section 351 transaction, the notes would probably be treated as the equivalent of stock, causing the interest deductions to be disallowed and payments of the notes to be taxed as a dividend. In addition to avoiding the perils of the thin corporation, the sale is designed to give the corporation a basis for the transferred assets equal to their fair market value. However these advantages will be lost if the notes are treated as the equivalent of stock. This could occur if the court finds the sale took place in concurrence with the incorporation so as to be a single transaction falling under Section 351.[41] If the transaction becomes a Section 351 exchange the notes could be treated as "boot" or as "securities" equivalent to stock. Or the court could easily find the notes to be stock if the sale gave the corporation an excessive debt-equity ratio.[42] But there still remains the question of the validity of the notes if the sale is made to a corporation that has an adequate debt-equity ratio.

The tax court recently raised the very question of whether evidences of indebtedness are to be considered as not bona fide merely because they are issued to the corporation's shareholders in exchange for assets required to get the business under way. In *Emanuel Kolkery v. Commissioner*[43] the court concluded that since the shareholders supplied everything the corporation needed to carry on the business in exchange for notes, that they intended to take the risks of the corporate adventure, and therefore the notes were the equivalent of stock. The court also found support for their conclusion by holding there was not valid a business purpose for the transaction. In *Estate of H. B. Miller v. Commissioner*[44] the tax court reached a similar result on the grounds that the partnership there involved transferred assets necessary to get the business under way to the corporation in exchange for stock and notes. Here also the tax court found support for its decision by holding that there was a lack of business purpose other than tax avoidance. In *Janeway v. Commissioner*[45] the court held notes issued in an exchange of assets to be stock on the grounds that the notes were exchange for advances constituting the corporation's sole source of working capital. This conclusion was supported by the fact that the stock and notes were issued in the same proportion. In *Bachrach v. Commissioner*[46] the court reached a similar result for similar reasons, but in that case the court had further support in the fact that notes were not issued for the loans.

On the other hand the court in *Warren Brown v. Commissioner*[47] held notes issued in exchange for assets required by the corporation to operate to be valid.

41. R. M. Gunn, 25 T.C. 424 (1955).
42. Sun Properties v. United States, note 30 *supra.*
43. 27 T.C. 37 (1956).
44. 24 T.C. 923 (1955).
45. 2 T.C. 197 (1943), *aff'd,* 147 F.2d 603 (2d Cir. 1945).
46. 18 T.C. 479 (1952), *aff'd,* 205 F.2d 151 (2d Cir. 1953).
47. 27 T.C. 27 (1956).

Here the court based its holding on the fact that there was a valid and sound business purpose behind the transaction. The *Miller* case, on appeal, was reversed on the grounds that there was a valid business purpose for the transaction, so that the transaction was not a sham and the notes were valid indebtedness.[48]

It seems clear that the tax court looks with disfavor on indebtedness issued by a closely held corporation to its shareholders in exchange for assets required to get the business under way. If the court can point to other disfavorable factors[49] it will convert the indebtedness into capital. If there are no other disfavorable factors present then the court looks to the purpose behind the transaction. If there is a valid business purpose, which is not a sham or a tax avoidance, the courts will recognize the indebtedness.[50]

IV—PARENT-SUBSIDIARY RELATIONSHIPS

All of the factors referred to above, used by the courts to determine whether there was intended a debt or an equity, apply equally as well to the parent-subsidiary corporation relationship. In *National Carbide Corp. v. Commissioner*[51] the court held that loans made by a parent to a subsidiary were in fact contributions to capital because the parent had supplied all the funds and assets required by the sudsidiary to operate. In *Eli E. Dorsey v. Commissioner*[52] loans were held to be contributions to capital because of an excessive debt-equity ratio. In *Kraft Foods Co. v. Commissioner*[53] the court analyzed the debentures in question in the same manner as if the parent was an individual stockholder. The court made a special point of stating that a debt should not be disregarded merely because of a parent-subsidiary relationship.

V—DEVICES SUGGESTED TO AVOID DEBT FINANCING PROBLEMS

Two noteworthy devices have been suggested to avoid the problems of debt financing. The first suggests the purchase by stockholders in their individual capacity of assets necessary for corporate operations, with the stockholders then loaning these assets to the corporation instead of creating a corporate indebtedness to purchase the property.[54]. This device seems rather complicated to be used solely for tax reasons. Also an extensive use of it might give rise to a questioning of the corporate form, and whether or not the corporation is merely an empty shell.

48. 239 F.2d 729 (9th Cir. 1956).
49. Notes 45, 46, *supra.*
50. Notes 43, 47, 48, *supra.*
51. 336 U.S. 422 (1949).
52. 15 T.C.M. 1101 (1956).
53. 232 F.2d 118 (2d Cir. 1956).
54. *The Thin Capitalization Problem Can be Beat,* J. TAXATION, May 1955. p. 286.

The second device suggested is that the corporation borrow from outside sources like banks, with stockholders guaranteeing the loans.[55] The purpose of this device would be to attempt to convert loss, on loans to corporations, from non-business bad debts (short term capital loss) into ordinary loss in a transaction entered into for profit (deductible in full in the year of loss). However, the advantages of this device seems to have been minimized by the recent decision in *Putnam v. Commissioner.*[56] The *Putnam* case has disapproved three of the cases on which the proponent of the device relied to support his contention that payments made by stockholders on guarantees are deductible as "incurred in a transaction entered into for profit."[57] In the *Putnam* case an attorney guaranteed loans to a corporation with which he was wholly unconnected. The Supreme Court held that payments he was required to make on the guarantees, after the corporation became insolvent, were only deductible as non-business bad debts and not as losses from a transaction entered into for profit. In its decision the Court disapproved the cases where the shareholder was allowed a loss from a transaction entered into for profit resulting from payments required to be made on a guarantee.[58] An even more drastic result could occur if the courts treated a guaranteed loan as a loan to the shareholder who passed it on to the corporation as a contribution to capital. *E. J. Ellisberg v. Commissioner*[59] though not directly in point held a guaranteed loan not to be such, but rather a gift from the guarantor to the borrower. This suggests that the court might treat guaranteed loans to a corporation as contributions to capital, and then the payments from the corporation would be treated as a dividend to the guarantor, and he, rather than the corporation, would have an interest deduction. If the debt-equity ratio of the corporation was excessive it would seem doubtful that a guaranteed loan would be held bona fide when a direct loan would not.

VI—CONCLUSION

It is well to remember that the court's primary consideration when confronted with a debt instrument of a closely held corporation is whether there was an intention to create a debtor-creditor relationship or to make a capital investment or contribution. This intention is to be gleaned from the entire transaction and its surrounding circumstances;[60] the form of the instrument, the ratio of debt to equity, the proportion in which the stock and debt are held, when the debt was issued, whether it was received in exchange for assets required to operate the corporation, and the purpose of the transaction.

55. *Capital Formation of Speculative Enterprises,* 34 TAXES 420 (1956).
56. 352 U.S. 82 (1956).
57. Fox v. Commissioner, 190 F.2d 101 (2d Cir. 1954); Pollak v. Commissioner, 209 F.2d 57 (3d Cir. 1954); Edwards v. Allen, 216 F.2d 794 (5th Cir. 1954).
58. Edwards v. Allen, note 57 *supra.* A complete discussion of the *Putnam* case and its effect on tax law can be found in: Brown, *Putnam v. Commissioner—The Reimbursable Outlay Under the Tax Law,* 6 BUFFALO L. REV. 283 (1957).
59. 9 T.C. 463 (1947).
60. Charles A. Polizzi, note 9 *supra.*

The most important of these factors seems to be the form of the instrument. The other factors do not seem to be applied as strictly as the "hybrid" factors; they do not seem to be as well settled or applied as uniformly. The identity-of-interest test has been watered down by the fact that two cases since the *Gooding* case have recognized debt despite an identity of interest.[61] The American Law Institute[62] indicates its conviction that the identity of ownership of stock and debt holdings should not be a relevant factor in determining the validity of loans by stockholders. The debt-equity ratio though relied on heavily in the past seems to be on the way out as a sole criterion for determining intent. If the *Rowan*[63] case is followed, an excessive debt-equity ratio alone will be insufficient to cause a debt to be treated as the equivalent of equity. The American Law Institute[64] suggests that there should be no upper limit upon the permissible ratio of pro rata debt to equity where substantial amounts of capital have been invested in the corporation.

When the court holds an instrument not to be a bona fide debt the entire issue of the instruments usually falls. A common question is what becomes of these instruments once they are held not to be bona fide debts? If the court characterizes the instruments as preferred stock, then the owners would be well advised to sell them, since a sale may avoid the dividend tax that would be imposed if they were held until retirement. A sale of the instruments would produce capital gain to the shareholder with their basis being determined under Section 358. The "interest" paid by the corporation to the new owners would continue to be non-deductible, but they would be entitled to a dividend-received credit. The retirement of the instruments would be treated as a redemption of stock under Section 302, and it would probably produce capital gain or loss under Section 302(b)(1) or 302(b)(3). Loans by shareholders are sometimes labeled "contributions to capital," the implications being that the instruments are to be totally disregarded. Pursuing this rationale, the entire proceeds from a sale of the instruments by the shareholder would be taxable, since there would be no offsetting basis, and the proceeds would be ordinary income rather than capital gain, since the "instruments" would not be properly within the meaning of the capital asset definition of Section 1221. The instrument might presumably come to life in the hands of the transferees, but whether they would be characterized as shares of preferred stock or authentic evidences of indebtedness is unclear. They might be characterized as evidences of indebtedness so far as the new owners are concerned but the corporation may be denied the interest deduction.[65]

By now it should be clear that the questions and problems in the tax area of

61. Kraft Foods Co. v. Commissioner, note 22 *supra;* Rowan v. United States, 219 F.2d 51 (5th Cir. 1955).
62. ALI FED. INCOME TAX STAT. Vol. II (Feb. 1954 Draft).
63. 219 F.2d 51 (5th Cir. 1955).
64. See note 62 *supra.*
65. These questions and others are raised and attempted to be answered in: *Thin Capitalization: Some Current Questions,* 34 TAXES 830 (1956).

corporate debt-equity financing are numerous and complex. The practitioner might well be advised to take each problem presented to him separately and compare it with all the related cases of the same type before making a decision. This is hardly an area where application of generalized principles will suffice in every case.

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