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TAX TREATMENT OF STOCKHOLDERS' ADVANCES (HOW THICK MUST BE A THIN CORPORATION)

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With higher corporate tax rates and more emphasis by the Treasury on taxing distributions to stockholders as dividends, the advantage in setting up stockholders' advances to a corporation as loans rather than as equity capital has become more marked. Many stockholders commencing risky, incorporated businesses would like to get their capital out of the corporation as soon as possible so as to minimize the risk of loss in the event business conditions should turn bad. A stockholder cannot receive a return of part of his equity capital without serious question as to his liability for tax on the distribution as constituting a dividend to the extent of any accumulated surplus. Loans to the corporation, however, if entitled to be treated as loans for tax purposes, can be repaid without any question of a taxable dividend. Furthermore, to the extent that interest is paid to the stockholder on the loan, the corporation receives a deduction. While the interest is taxable to the stockholder, nevertheless, to the extent of the deduction thus secured by the corporation, there is avoided the double tax which results when income of the corporation is taxed to the corporation and then distributed to, and taxed again in, the hands of the stockholder.

I. TREASURY CHALLENGE TO STOCKHOLDERS' LOANS—ORIGIN OF THIN CAPITALIZATION CONCEPT.

Because of the tax avoidance possibilities in loans, the Treasury has attempted to find ways and means of treating advances by stockholders to corporations as equity capital rather than as borrowed capital. In the earlier years, this attempt mostly consisted of taking the position that the particular security issued did not in fact create a debt for the reason that it did not have a definite maturity date, that payment was dependent upon earnings, or that it had other hybrid features. As time went on, however, most corporations were set up with proper advice and issued bonds or notes or created open accounts as to which there could be no question that they were in the usual form of debt obligations.

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Advance warnings of a new line of attack came during World War II in cases like *Edward G. Janeway*,¹ and *Joseph B. Thomas*.² These decisions involved stockholders' advances to a corporation where the result of holding that they created a bona fide indebtedness would have been to leave the corporation with little or no actual paid-in equity capital. The courts refused to regard these advances as constituting borrowed capital of the corporation under such circumstances. State requirements as to minimum paid-in capital, if nothing else, would seem to support these decisions.

In 1946, Mr. Justice Reed, delivering the opinion of the Supreme Court in the case of *John Kelley Co. v. C. I. R.*,³ included a remark which started off a chain reaction in this field, the consequences of which are not yet completely charted. The case involved the question of whether deduction of interest on certain corporate debentures was to be denied because there was no bona fide debt. The decision, however, went off on the ground that the Tax Court's determination of this matter would not be upset if supported by any facts. In the course of the opinion, Justice Reed states⁴: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." This remark appeared to be a warning by the court that where the equity capital of a corporation was nominal as compared to the borrowed capital, this factor in itself would affect the determination of whether the borrowed capital would be regarded as a bona fide indebtedness for tax purposes.

Looking backwards, it would appear that the remark of Justice Reed may have grown out of considerations not peculiar to the tax field. In 1939, in the decision of *Pepper v. Litton*,⁵ a bankruptcy case involving priority of claims rather than taxes, Justice Douglas stated that so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors, and thus treated in effect as capital contributions by the stockholder, where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan. In support of this statement, Justice Douglas cited *Albert Richards Co. v. The Mayfair*.⁶ In that case, the court

¹ 2 T. C. 197 (1943), *aff'd*, 147 F. 2d 602 (C.A. 2d 1945).

² 2 T. C. 193 (1943).

³ 326 U. S. 521 (1946).

⁴ *Ibid* at 526.

⁵ 308 U. S. 295 (1939).

⁶ 287 Mass. 280, 191 N.E. 430 (1934).

found that not more than \$5,000.00 or \$6,000.00⁷ had been paid in for stock of a corporation which required immediate expenditures of over \$75,000.00 and the court refused to give the stockholder the status of a creditor for the money loaned by him to the corporation.

If advances by the majority stockholder will not be recognized as a debt in a controversy with other creditors of the corporation, there can be said to be no reason why the advances should be recognized as a debt between the stockholder and the Treasury. *Pepper v. Litton, supra*, and *John Kelley Co. v. C. I. R., supra*, would make it appear that the Supreme Court may regard stockholders' advances to a thinly capitalized corporation as not creating a creditor status, either with regard to other creditors or with regard to federal income taxation, even though all the ordinary legal indicia of a debt are present.

This suggestion thrown out by the Supreme Court was immediately seized upon by the lower courts and they have run with the ball. No attempt will be made here to list or discuss all of the cases involving this so-called "thin capitalization" doctrine but the more important cases not otherwise mentioned in this article are set out in a footnote.⁷

II. FACTS LEADING TO APPLICATION OF THIN CAPITALIZATION DOCTRINE.

Two necessary conditions precedent to an ignoring of creditor status were suggested by the Supreme Court in the *Kelley* case; namely, that the stock investment is nominal and that there is an obviously excessive debt structure. Many of the lower courts have seized on the second of these, the obviously excessive debt structure, as being the only matter of importance and have extended the thin capitalization doctrine to situations where substantial equity capital has been paid into the corporation.

In *Joseph H. Hubbard*⁸ all of the assets of a partnership totaling \$80,000.00 were transferred to a corporation for \$50,000.00 stock, and book entries reflecting \$30,000.00 indebtedness. The Tax Court held that since all the assets were needed in the business, the entire \$80,000.00 would be treated as equity capital. This is the most recent and extreme extension of the thin capitalization rule yet made.

⁷ *Pierce Estates, Inc. v. C. I. R.*, 16 T. C. 1020 (1951), *rev'd on another ground*, 195 F. 2d 475 (C.A. 3rd 1952); *Kipsborough Realty Co.*, P-H 1951 TC MEM. DEC. SERV. ¶ 51,291; *Hilbert L. Bair*, 16 T. C. 90 (1951); *George L. Sogg*, P-H 1950 TC MEM. DEC. SERV. ¶ 50,251, *aff'd*, 194 F. 2d 540 (C.A. 6th 1952); *Samuel T. Tauber*, P-H TC MEM. DEC. SERV. ¶ 52,082; *Swoby Corp.*, 9 T. C. 887 (1947); *Mullin Bldg. Corp.*, 9 T. C. 350 (1947), *aff'd*, 167 F. 2d 1001 (C.A. 3rd 1948); *New England Lime Co.*, 13 T. C. 799 (1949); *R. E. Nelson*, 19 T. C. No. 72 (1952).

⁸ P-H 1952 TC MEM. DEC. SERV. ¶ 52,287 (1952).

In *Powers Photo Engraving Co., Inc.*⁹ the stockholders contributed \$30,000.00 for stock plus \$36,500.00 paid-in capital surplus and advanced \$107,000.00 in loans. Certainly the sum of \$66,500.00 must be considered to be more than a nominal equity capital investment. Yet both the Tax Court and the Court of Appeals held that the \$107,000.00 was not to be treated as a debt of the corporation.

In *Alfred R. Bachrach*¹⁰ the stockholders invested \$1,200.00 in stock and made \$14,000.00 in loans to the corporation. \$1,200.00 is not entirely nominal in a corporation with total assets of \$15,000.00. Nevertheless, the Tax Court held the loans to be equity capital.

In *Erard A. Matthiessen*¹¹ \$6,500.00 was paid in for stock and \$20,000.00 was loaned to the corporation at the time of organization and an additional \$78,000.00 later loaned to the corporation. \$6,500.00 certainly is not nominal, yet both of the Courts held that the loans were equity capital.

In *Isidor Dobkin*¹² \$2,000.00 was paid in for stock and \$26,000.00 was loaned to the corporation. In a corporation with total assets of \$28,000.00, \$2,000.00 would not seem to be entirely nominal. Both Courts, however, held the loan to be equity capital.

In *Sam Schnitzer*¹³ the stockholders put in \$187,000.00 for stock and approximately \$1,500,000.00 as loans. Obviously, \$187,000.00 is not nominal, yet both of the Courts held that part of the loans were to be treated as equity capital.

On the other hand, in *Arthur McDermott*¹⁴ there was an investment in stock of \$5,500.00 and loans to the corporation of \$108,000.00. The Court held that the loans created valid debt obligations, although the difference between this and the other cases is hard to see if we are looking merely at the question of whether there is or is not a nominal stock investment.

In *B. M. C. Manufacturing Corporation*¹⁵ \$2,800.00 was paid in for stock and \$250,000.00 was loaned to the corporation on an issue of debentures. The Court held that the debentures were valid debt obligations, relying in part on the existence of an earned surplus of \$116,000.00.

⁹ 17 T. C. 393 (1951), *aff'd on this point but rev'd on another ground*, 197 F. 2d 704 (C.A. 2d 1952).

¹⁰ 18 T. C. No. 57 (1952).

¹¹ 16 T. C. 781 (1951), *aff'd*, 194 F. 2d 659 (C.A. 2d 1952).

¹² 15 T. C. 31 (1950), *aff'd*, 192 F. 2d 392 (C.A. 2d 1951).

¹³ 13 T. C. 43 (1949), *aff'd*, 183 F. 2d 70 (C.A. 9th 1950).

¹⁴ 13 T. C. 468 (1949).

¹⁵ P-H 1952 TC MEM. DEC. SERV. ¶ 52,106 (1952).

In *Earle v. W. J. Jones & Son, Inc.*^{15a} the stockholders put in \$1000 for stock, contributed \$50,000 in property as paid-in capital, and loaned \$317,106 to the corporation over a period of years. Despite the large ratio of loans to equity capital, the court held that the loans created bona fide debts.

Any analysis of the cases makes it obvious that they cannot be rationalized in terms of only the debt to stock ratio, or of only the question of what constitutes a nominal investment. The courts continue to look at all of the circumstances that bear on the real intention of the stockholders. In addition to the small amount of a stock investment and the large ratio of debt, facts were present in many cases which indicated no real evidence that an actual indebtedness was intended at the time the money was paid into the corporation. In some cases, when the money was paid in, there was very sketchy or incomplete book-keeping so as to offer little certainty that the money was intended as an actual open account debt advance and no notes or other formal evidences of indebtedness were issued. In other cases, demand obligations were issued, with the corporation being unable to pay off the obligations, had a demand been made, without liquidating the basic capital assets of the corporation. The courts decided that the stockholder did not intend the corporation to pay the note on demand, but rather intended the money given to the corporation to be a long term investment.

In still other cases, the courts have relied upon the fact that the indebtedness was issued in the same ratio as was the stock of the corporation. Other decisions have looked to the question of whether the indebtedness was secured or unsecured and whether there were any minutes wherein the directors or stockholders had made any determination as to what should be capital and what should be indebtedness. Where the determination of this matter was merely left to the accountant to set it up on the books in any way he saw fit, the courts usually held it was all equity capital no matter how he set it up. The fact that the loans represent unidentified portions of a single investment also has been thought to militate against a debt status.

Where indebtedness has been subordinated to other creditors to such an extent that it is difficult to see the practical difference between the indebtedness as issued and equity capital, the courts have held that no real debt was intended. In many cases, also, advances were made to corporations that were insolvent at the time of the advances and the

^{15a} C.A. 9th Decided December 24, 1952.

courts have held that there was no real expectation of repayment which would have been present if a bona fide loan had been made.

III. STEPS WHICH WILL HELP PROTECT A CORPORATION FROM APPLICATION OF THIN CAPITALIZATION DOCTRINE.

While these decisions are in a state of confusion at the present time, nevertheless, if we analyze the cases carefully, some outlines of a reasonable policy to follow can be drawn. In the first place, although the lower courts have to some extent ignored one of the two conditions precedent to the application of the doctrine as stated by the Supreme Court, namely, the requirement that the stock investment be nominal, still it is entirely possible that when the issue finally again reaches the Supreme Court, that Court will hew very closely to a concept that can be used both in tax cases and in creditor cases. That concept could well continue to limit application of the thin capitalization doctrine to instances where there was actually a nominal stock investment.^{15b} Meanwhile, however, the cases are coming before the lower courts, which seem to be paying more attention to the size of the debt structure as compared to the equity capital than to the question of whether the equity capital is actually nominal.

The thin capitalization doctrine has most often been applied to the securities issued at the time of incorporation of a new, closely held company. This creates a real problem for the lawyer because if he is to properly advise his clients at the time they incorporate a new company, he will tell them that as large a percentage as is possible of the money they are putting into the corporation should be loaned rather than invested for stock. The limit on this practice is fixed, first, by business considerations as to what sort of a balance sheet and credit rating the corporation will need, and, secondly, by the thin capitalization doctrine. In many cases, it is advantageous to skate along the ragged edge of application of the thin capitalization theory. The considerations discussed below may help one stay on the right side of this ragged edge.

In all corporations, there should be material amounts invested in stock. What is "material" will, of course, be largely thought of in relation to the size of the corporation and the nature of the assets to be originally purchased. \$1,000.00 in stock obviously is not material

^{15b} In *Earle v. W. J. Jones & Son, Inc.*, *supra*, note 15a, Judge Bone, in holding advances to a corporation to be debts, stated, citing *John Kelley Co. v. C. I. R.*, *supra*, note 3, "certainly there were 'material amounts of capital' invested in stock."

if the original capital requirements of the corporation are to be a million dollars, but \$1,000.00 in stock is material if the original capital requirements are to be \$3,000.00 or \$4,000.00.

Some writers on this subject have taken the view that in no case should there be a ratio of debt to equity capital exceeding 4 to 1. There would not seem to be, however, any magic in a 4 to 1 or other fixed ratio. The courts have sustained, and probably will continue to sustain much higher debt ratios where the stock investment is material and where all of the other facts point to the existence of a bona fide indebtedness.

Common sense is probably the most important standard to use in determining how much to put in for stock and how much to loan to the corporation. One should keep in mind that ordinarily equity capital finances the larger part of the fixed assets of a business, and borrowed capital finances the balance of the fixed assets and the inventories and receivables. Even where the transactions are all with outsiders and all at arms length, many, if not most, corporations do not commence with sufficient equity capital to pay for all of the fixed assets of the business. They borrow on mortgage or otherwise a substantial part of even the fixed asset capital. Where the borrowed and equity capital both are to come from the stockholders, one may reasonably fix the equity capital at a point where, if the corporation were dependent entirely upon outside credit, it could borrow the balance of its capital on mortgages on its fixed assets, and on loans secured by its inventories and receivables. A corporation so organized should be defensible from a thin capitalization standpoint.

Where the loans are secured from outsiders, they would be, of course, evidenced by formal bonds or notes and normally security is given. Consequently, where the stockholders are making the loans, the transaction appears more bona fide if the same is done. The more formal the instruments that are issued, the more difficult, at least psychologically, it is to ignore them and call them equity capital. For this reason, notes are better than open accounts and bonds are better than notes. Maturity dates should be sufficiently long so as to make it probable that if the corporation is successful, the bonds or notes can be retired without the sale of any of the basic assets needed for the business.

If the corporation is being financed largely by stockholders' open account advances from day to day or week to week, the execution of a written agreement ahead of time between the corporation and the

stockholders may be desirable, in which provision is made for the forthcoming advances, the character of these advances as debts is definitely stated and the types of securities eventually to be issued for the advances are definitely set forth. Wherever day to day or frequent open account advances are being made by a stockholder to a corporation, it would be well to convert these open accounts into notes or other securities quite frequently, perhaps monthly.

Of utmost importance, of course, is to show the advances as debts on the books of the corporation and on every financial statement issued by the corporation. Moreover, when the obligation becomes due, it should not be simply ignored but some action should be taken with regard to it such as would be taken if it were a loan from an outsider. A step which is consistent with actual banking practice is to make some payment on account and renew the balance or if no payment can be made, then at least a renewal note should be executed and some reference made in the minutes or other documents of the corporation as to the reasons for the extension.

Payment of interest on the obligation has not only the tax advantage of giving the corporation an additional deduction but also the further advantage of making the debt appear as more of a bona fide obligation.

Where loans are made to the corporation by all of the stockholders and strictly in accordance with the relative percentage holdings of the stock, suspicion as to the nature of the advances is immediately created. In many situations, it is difficult to do otherwise since each of the stockholders is reluctant to take a risk greater than any other stockholder. Wherever possible, however, the stockholders should be persuaded to make the advances in proportions different from their holdings of stock. In some of the decisions even very small differences in this respect have been the turning point in the recognition of the advances as creating debt obligations.¹⁶

The extent to which obligations issued to the stockholders are subordinated to other creditors is looked at by the courts in determining whether the obligations constitute a debt. In many cases, practical considerations make it necessary to subordinate the obligations to certain other creditors; for example, if money is being borrowed from a bank, the bank will almost always require that any obligations to the stockholders be subordinated to the bank. While any subordination

¹⁶ Arthur V. McDermott, 13 T. C. 468 (1949). Also see the following cases which stressed the fact that the advances were not in proportion to the stockholdings: B.M.C. Manufacturing Corp., P-H 1952 TC MEM. DEC. SERV. ¶ 52,106 (1952); Weldon D. Smith, 17 T. C. 135 (1951); New England Lime Co., 13 T. C. 799 (1949).

may raise some question as to the nature of the obligation, nevertheless, a subordination only to certain creditors should not materially affect the case. A blanket subordination to all creditors, however, would cast serious doubt on whether the stockholders had a creditor or an equity position as far as the advances were concerned.

Where stockholders are making loans to the corporation every bit of formality should be observed. There should be formal board of directors' resolutions approving the loans and authorizing the issuance of the securities and the securities should be in complete legal form in every respect.

Where advances are made to a corporation that is in serious financial trouble, the nature of the obligation as a debt may be questioned on the ground that there was no real expectation of repayment at the time of the advance. If the corporation is actually insolvent when the advance is made, it is difficult to secure debt treatment.¹⁷

Where a corporation has been in existence for some time, it would seem proper to consider any accumulated surplus in connection with a determination of whether the thin capitalization doctrine should be applied.¹⁸

IV. USE OF THIN CAPITALIZATION DOCTRINE ON BEHALF OF THE TAXPAYER.

The doctrine of thin capitalization is a sword not merely in the hands of the commissioner but also in the hands of the taxpayer. One use of it by the taxpayer may be to increase excess profits tax credit. In *Powers Photo Engraving Co., Inc. v. C. I. R.*,¹⁹ it was held that advances set up on the books of the corporation as loans from stockholders were actually to be treated as equity capital because of thin capitalization and that, consequently, the corporation was entitled to include these advances in computing its excess profits tax credit as equity capital rather than as borrowed capital. Where a corporation is or has been in any year in excess profits tax brackets and where substantial loans have been made to the corporation by the stockholders, careful consideration should be given to whether there would be an advantage to the corporation in affirmatively taking the position that, because of the thin capitalization doctrine, the loans were not to be regarded as creating debts but as constituting equity capital with a correspondingly larger excess profits tax credit.

¹⁷ Fred A. Bihlmaier, 17 T. C. 620 (1951); George B. Markle, 17 T. C. 1593 (1951).

¹⁸ B.M.C. Manufacturing Corp., P-H 1952 TC MEM. DEC. SERV. ¶ 52,106 (1952).

¹⁹ 197 F. 2d 704 (C.A. 2d 1952).

Another use of this doctrine may be to increase the cost basis of a security at the time it is paid off or the time the corporation is liquidated. *Bauman v. U. S.*²⁰ involved notes which the Tax Court had previously held to be actually equity capital. Payments had been made for many years on the *principal* of these notes. Upon dissolution of the corporation, the holders of these notes claimed that the payments on principal of these notes were, because of the Tax Court decision, and because of the existence of a surplus, to be treated as dividends on stock and consequently that they did not reduce the cost basis of the securities for purpose of computing the gain or loss when the securities were retired. The Court held with the taxpayers, but permitted the Government to offset against the refunds the amount of income tax that should have been paid by the taxpayers on the so-called dividends, the statute of limitations not applying because of I.R.C. § 3801(b)(5).

²⁰ 106 F. Supp. 384 (E.D. Mo. 1952).