Boston College Law Review

Volume 8
Issue 4 *Number 4*

Article 13

7-1-1967

Taxation—Deduction of Debt Interest—Effect of Subordination of Debt.—United States v. Snyder Bros.

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Taxation—Deduction of Debt Interest—Effect of Subordination of Debt.—*United States v. Snyder Bros.*[1]—Plaintiff was a close corporation which was formed when two brothers, formerly equal partners in a partnership, transferred substantially all of the assets of their partnership to the plaintiff corporation. In exchange for these assets, the plaintiff corporation assumed the liabilities of the partnership and issued capital stock worth $100,000 and "subordinated debentures" in the principal amount of $140,000. Each partner received one-half of the capital stock and one-half of the debentures. By their terms, the debentures contained an absolute promise to pay the principal sum twenty years from their date, with interest at six per cent per annum payable semiannually. The debentures were expressly subordinated "to all indebtedness of the Company whether outstanding at the date of this Note or incurred and not subordinated [thereafter] . . . ."[2] No limit was placed upon the amount of the superior indebtedness. The debentures further provided that the subordination provisions were to take effect in the event of insolvency or bankruptcy proceedings or in the event of a default by the corporation on the principal or interest due on the subordinated debentures. There was no restriction on the payment of dividends in the event that the corporation fell behind in interest payments on the debentures.

Payment of the semiannual "interest" was made as required. Plaintiff sought to deduct the payments as interest on indebtedness on its federal income tax return. The Commissioner disallowed the deduction and assessed a deficiency on the ground that the debentures did not represent true indebtedness within the meaning of Section 163(a) of the Internal Revenue Code, but rather represented an investment in the nature of preferred stock. Plaintiff paid the deficiency and brought suit for a refund in the district court. The court directed a verdict for the taxpayer, and the government appealed. The Fifth Circuit Court of Appeals HELD: Debentures which are expressly subordinated to all indebtedness of a corporation, and which are issued to the corporation's sole stockholders in proportion to their stockholdings, are not "indebtedness," and thus the interest thereon may not be deducted by the corporation.[3]

Section 163(a) provides that there "shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." This relatively simple, straight-forward provision has given rise to an impressive volume of litigation.[4] Each case has attempted to determine whether the particular security under consideration was indebtedness of the issuer, in which case payments made thereon would be deductible interest, or an equity investment, resulting in dividend payments for which no deduction is allowed.[5] In

[1] 367 F.2d 980 (5th Cir. 1966), cert. denied, 35 U.S.L. Week 3319 (U.S. March 14, 1967).

[2] Id. at 986.

[3] Id. at 983-84.

[4] 3 P-H 1967 Fed. Tax Serv. ¶ 13096.

[5] The ramifications of a decision that a given security is indebtedness rather than an equity investment are more far-reaching than the interest deduction. The tax treatment upon redemption of the security can vary greatly as a consequence of whether the security is indebtedness or equity. If the security is held to be "indebtedness," its retirement will be treated as an exchange if the indebtedness is a "capital asset" in the hands of

view of the consequences of the classification of securities, one would expect the word "indebtedness" to be defined in the Code. However, Congress has not seen fit to define the word, and section 163(a) has been plagued by uncertainty ever since the present wording was adopted in 1918. In the absence of an explicit statutory definition, the courts have promulgated definitions based upon their concept of what Congress meant when it used the word. Basically, these court-made definitions, although variously phrased, include the same criteria for distinguishing debt securities from equity investment, but the emphasis placed upon the various components in the definition may vary, depending upon the particular security being analyzed.[6] Typical of the judicial definitions is one from the Second Circuit which defined the "classic debt" as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."[7] An equity investment, on the other hand, represents a part ownership in the assets of the corporation, gives the holder a right to participate in the management of the corporation and to share in the surplus profits, and, on dissolution, allows the holder to share in the assets which remain after the debts are paid.[8] The essential difference between the two types of investments is that the shareholder, by allowing his investment to become permanent, takes a greater risk of loss, both of the periodic return on his investment and of his total investment, so that he may enjoy the chance of profit; the creditor, on the other hand, avoids this risk by demanding adequate safeguards for the return of his investment in the not-too-distant future.[9]

Unfortunately, all securities are not easily categorized as debt or equity. The difficulty is caused by the countless variations that may be added to the "classic debt" definition which may change its character from debt to equity. When a security has been varied so that it has some characteristics of debt

the taxpayer. Int. Rev. Code of 1954 (IRC), § 1232(a)(1). This, in turn, will result in capital-gains treatment with the only tax being upon the amount received in excess of basis. IRC § 1232(a)(2)(A). On the other hand, if the security is held to be an equity investment, the security will be treated as redeemed if the corporation acquires it in exchange for property. IRC § 317(b). If stock is redeemed, and if § 302(a) does not apply, the "redemption shall be treated as a distribution of property to which section 301 applies." IRC § 302(d). If the distribution is essentially equivalent to a dividend, § 301 will apply and it will be included in gross income. IRC § 301(c)(1). Since "essentially equivalent" is construed very broadly, IRC § 302(b)(1), many redemptions will be considered within this term and therefore will be treated as ordinary income in contrast to the capital-gains treatment accorded the "redemption" of indebtedness.

6 One court, while mentioning the many factors which make up the debt instrument, held that the fixed maturity date is the most significant factor in differentiating debt from equity. Commissioner v. H. P. Hood & Sons, 141 F.2d 467, 470 (1st Cir. 1944). On the other hand, another court has held that the most significant characteristic of the debtor-creditor relationship is the "right to share with general creditors in the assets in the event of dissolution or liquidation." John Wanamaker Philadelphia v. Commissioner, 139 F.2d 644, 647 (3d Cir. 1943). These cases and others which place special emphasis upon a particular factor are consistent with each other; the emphasis on the factor being stressed is a result of the peculiar characteristics of the security under consideration.

7 Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957).

8 6A Fletcher, Corporations § 2635 (perm. ed. rev. repl. 1950).

9 See United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

and some characteristics of equity, it is called a "hybrid security."[10] In the only hybrid case to reach the Supreme Court,[11] it was held that "there is no one characteristic . . . which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."[12] The instant case, involving a hybrid security, supports the position that no one factor is determinative; the court appears to have emphasized at least two significant factors in finding an equity investment: subordination to all creditors and identity of interest between the stockholders and the debenture holders.

Whether a security which is subordinated represents debt or equity depends upon the combination of factors which are present in the particular case under consideration. As the factors vary, so will the result vary. Surprisingly, the cases dealing with subordination offer little help in relating the subordination factor to the solution of the debt-equity question. Most of the courts have substituted general statements for analysis. Among the most influential of the generalities have been the following: (1) "Debt is still debt despite subordination";[13] (2) "We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors";[14] and (3) subordination creates "a strong presumption that the interest in question is that of a stockholder."[15] It is unfortunate that such pronouncements have been followed by subsequent courts in a manner which has created a line of unreasoned precedent.[16] As an alternative, it is submitted that the court should analyze certain factors which have particular relevance to the subordination provision before such provision is held to indicate debt or equity. Only after such an analysis can the subordination provision be considered in relation to all the other factors in order to determine whether the instrument, as a whole, represents debt or equity. Among the elements of subordination which must be considered are the nature of the subordination provision itself, the amount of superior securities outstanding, whether the subordinated security is inferior to all or less than all of the outstanding debt of the corporation, and the character of the party or parties

[10] One writer has suggested that a "reasonableness" standard should be applied to the interest deduction on hybrids owned by shareholders: in other words, the deduction should be limited to a reasonable amount, with the excess deemed to be a dividend. The taxpayer would have to show, in effect, that part of the investment is debt and part is equity, with a deduction being allowed to the extent of the former. Instead of the present all-or-nothing approach, the taxpayer will get at least a partial deduction. Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1 (1960). As a practical matter, such an approach would seem to be much more difficult than the present method, since, if it is difficult to determine whether an instrument as a whole is debt or equity, it will be even more difficult to determine the extent to which a particular security represents debt and the extent to which it represents equity.

[11] John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).

[12] Id. at 530.

[13] Kraft Foods Co. v. Commissioner, 232 F.2d 118, 125-26 (2d Cir. 1956).

[14] Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935).

[15] Jordan Co. v. Allen, 85 F. Supp. 437, 447 (M.D. Ga. 1949).

[16] See, e.g., Security Fin. & Loan Co. v. Koehler, 210 F. Supp. 603 (D. Kan. 1962); M. & M. Corp., 18 CCH Tax Ct. Mem. 1051 (1959); Roosevelt Hotel, Inc., 12 CCH Tax Ct. Mem. 568 (1953).

holding the subordinated security. The latter element includes the identity of interest which the instant court stressed in reaching its conclusion.

There are two types of subordination—complete and inchoate. Both types of subordination, either by agreement or by operation of law,[17] require that certain other superior obligations receive full payment before any payment is allowed on the subordinated security. It must be noted, however, that the superior and the subordinated or junior securities are unsecured, and therefore are inferior to any secured creditor. Thus, the effect of a subodination provision is to create a system of preferences within a particular class of creditors, usually the class of unsecured creditors. The type of preference which is created depends upon the subordination provision itself; therefore, it is necessary to examine the various provisions in order to determine their effect.

A *complete* subordination agreement is one which permits no payment of principal or interest on the subordinated security so long as a specific superior debt is outstanding.[18] The completely subordinated security may have a fixed maturity date upon which the principal must be paid; however, if the superior obligation is still outstanding on that date, the subordinated security cannot be repaid.[19] Thus the likelihood that the superior security will be fully repaid on the maturity date of the subordinated security is the determinant of whether such maturity date is meaningful. Such a contingency removes the independent significance of the subordinated security's maturity date—a result which is evidence of the permanency of the investment and of the increased risk of total loss which accompanies permanency. These factors indicate an equity investment. This indication, caused by the compromising of the maturity date, is reinforced by the denial of the right to share equally with other creditors upon liquidation of the business.[20] The instant case does not fall within the complete subordination category, since there was no provision in the debenture prohibiting payment while the superior debt was outstanding. On the contrary, the debentures were subordinated only in specified situations, and if those situations did not occur, the unconditional obligation to the subordinated creditors would still have to be met.

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[17] A debt instrument that is not expressly subordinated may be subordinated in bankruptcy by operation of law if it is held by controlling shareholders who have been guilty of fraud or mismanagement. See Pepper v. Litton, 308 U.S. 295 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1938). The doctrine of subordination as a matter of law has also been applied in a case where there was only pro rata holding of stock and debt. In re V. Loewer's Gambrinus Brewery Co., 167 F.2d 318 (2d Cir. 1948). In addition, the doctrine has been referred to in an interest-deduction case. Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956). That court pointed out that debt will be "recognized" unless it has its "origin in mismanagement or overreaching" by controlling shareholders. Id. at 124-25. See also Janeway v. Commissioner, 147 F.2d 118 (2d Cir. 1956). The existence of this doctrine may arguably be used by the Commissioner, in certain circumstances, to rebut a contention that the absence of a voluntary subordination provision is favorable to the taxpayer. See generally Baker & Cary, Cases and Materials on Corporations 396-400 (3d ed. 1959).

[18] Calligar, Subordination Agreements, 70 Yale L.J. 376, 377-78 (1961).

[19] P. M. Fin. Corp. v. Commissioner, 302 F.2d 786 (3d Cir. 1962); Randolph D. Rouse, 23 CCH Tax Ct. Mem. 1823, 1837 (1964).

[20] P. M. Fin. Corp. v. Commissioner, supra note 19, at 789-90.

When an instrument is subordinated only upon the occurrence of a particular event, it is said to contain an *inchoate* subordination agreement.[21] Usually, the triggering event is either bankruptcy, insolvency, or some other type of voluntary or involuntary distribution of assets. Until the triggering event occurs, the subordinated security is treated as any other debt; that is, it "may be amortized, payments may be made to a sinking fund . . . , or [it] may be redeemed or refunded . . ." notwithstanding the fact that the superior debt is outstanding.[22] Unless the subordination provision is triggered, payment must be made on the maturity date, and, if it is not made, the holder of the subordinated security may enforce his right to repayment. Thus there is a distinct contrast between the efficacy of the maturity date in the complete and in the inchoate subordination provisions. When the latter provision exists, the chances of the maturity date being effective are substantial, since it must be respected unless the triggering event occurs. Of course, the possibility of that event occurring is a factor which must be weighed in determining the degree to which the inchoately subordinated security is subject to the risk of total loss. The point being emphasized is that the inchoately subordinated security is less subject to the risk of total loss than the completely subordinated security, and that the former is therefore less like an equity investment than a security which is completely subordinated. The instant case failed to discuss this distinction; however, its conclusion that the inchoately subordinated instrument was an equity investment may still be correct if other considerations more strongly indicate an equity investment and outbalance the normal tendency of inchoateness to indicate debt.

Fundamental among the considerations which might outbalance the normal tendency of inchoateness to indicate debt is a concept which will be referred to as the "asset-liability" principle. That principle compares the relationship between both the amount of superior debt outstanding and the amount of subordinated debt outstanding to the amount of assets potentially reachable by both. As a general rule, if at the time of the creation of the subordinated debt, the assets of the business are sufficient to cover only the superior securities, then the risk of loss on the subordinated securities is high. This indicates the likelihood that they were intended to be a permanent investment, and permanency, of course, is a characteristic of equity rather than debt. If, on the other hand, the assets of the business are sufficient to insulate both the superior and the subordinated securities, the risk of loss on the subordinated securities is low, which, in terms of the debt-equity issue, means that there is a greater certainty of repayment; this, in turn, indicates a temporary investment and therefore supports a finding that the subordination provision represents indebtedness.[23]

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[21] Calligar, supra note 18, at 377-78.

[22] Id. at 378.

[23] If a corporation has $1000 in reachable assets and has outstanding $500 in superior debts and $500 in subordinated securities, the "asset-liability" principle would apply and would indicate a holding that the subordinated security represents indebtedness. If, on the other hand, the corporation has $1000 in reachable assets and has outstanding $1000 in superior debts and $500 in subordinated securities, the "asset-liability" principle would

All cases, however, cannot be decided by an analysis based upon the amount of superior and subordinated debt outstanding and the amount of insulating assets. Cases will arise in which the subordinated security is only partially insulated by the assets. In these cases, any indication given by such an analysis does not appear to be strong enough to decide the debt-equity issue one way or the other. In short, in these cases the "asset-liability" principle is inconclusive.[24] Often, however, another principle may be helpful. An examination of the interest-deduction cases which have dealt with subordination yields a factual distinction which has not been articulated by the courts, but which nevertheless suggests a general principle for this more difficult group of cases involving partial insulation. The distinction rests upon the different results which have been reached when there has been subordination to *less than all* creditors rather than subordination to *all* creditors. In the former situation, most of the cases hold that the security represents indebtedness,[25] while in the latter, the results are usually that the security is equity.[26]

The primary reason for using the "all-less than all" distinction, within the class of cases in which the amount of debt outstanding in relation to available assets is inconclusive, appears to be that in the case of subordination to all creditors, there will normally be a smaller residue for payment to the junior securities after the superior debt has been paid than there would be if subordination were to less than all creditors. Therefore, the risk of loss on the subordinated securities is greater when there is subordination to all other

again apply and would indicate a holding that the security represents equity. Each of these cases falls within the general rule. In the former, the subordinated security is completely insulated against risk of loss by the reachable assets, whereas in the latter case, none of the subordinated security is insulated against the risk of loss, because there are only enough assets to protect the superior securities.

24 Assume a corporation with $1000 in assets, $500 in subordinated securities, and $750 in superior obligations. In such a case, if there were an immediate liquidation, the superior securities would recover $750, and there would be $250 left for the subordinated securities. Since only one-half of the subordinated securities will be covered, the "asset-liability" principle gives no conclusive indication of debt or equity.

To a somewhat lesser degree, this inconclusiveness can be seen in another factual situation. Assume a corporation with $1000 in assets, $500 in subordinated securities, and $750 in other obligations, only $500 of which is superior. In such a case, after the $500 in superior claims are satisfied, there remains $500 for division between the $500 in subordinated securities and $250 in securities which were not expressly made superior. A liquidation in this case would again result in a partial insulation of the subordinated security, since this security will only be covered to the extent of two-thirds of its investment. Although the subordinated security will be two-thirds covered in the latter case and only one-half covered in the former, it does not appear that there is enough of a differential between the two cases to make a distinction that amount is inconclusive in the former and conclusive in the latter.

25 See Atlantic Acceptance Corp. v. Tomlinson, 2 Am. Fed. Tax R.2d 5965 (D. Fla. 1958); Gordon Lubricating Co., 24 CCH Tax Ct. Mem. 697 (1965); M. & M. Corp., supra note 16. See also Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949).

26 See McSorley's, Inc. v. United States, 323 F.2d 900 (10th Cir. 1963); R. C. Owen Co. v. United States, 149 Ct. Cl. 96, 180 F. Supp. 369 (1960); Joseph W. Hambuechen, 43 T.C. 90 (1964); Schneider Lumber Co., 15 CCH Tax Ct. Mem. 120 (1956). But see Commissioner v. O.P.P. Holding Corp., supra note 14; Roosevelt Hotel, Inc., supra note 16.

securities than when there is subordination to less than all other securities, because the certainty of repayment is reduced. That, in turn, suggests that the security is a permanent investment—equity rather than debt.[27]

The analysis of the subordination issue from two points of view—the "asset-liability" principle and the "all-less than all" principle—has been an attempt to determine the extent to which the subordinated security holder can *reasonably expect to recover his investment*. There are additional factors which should be considered, however, because they mitigate or aggravate the results reached by the previously analyzed theories on the issue of reasonable expectations. The first of those factors is the ability of the debtor to service its debt, that is, to meet its interest payments and any other periodic payments, such as those involved in a sinking fund. This factor is especially important when inchoate subordination exists, because the failure to meet such periodic payments will usually be one of the events which triggers the subordination provision. Once the provision is triggered, the subordinated security's chances of repayment would depend upon either of the general principles, but to the extent that the debtor has the ability to service its debt and thus to prevent the triggering of the subordination provision, those principles may be neutralized. Therefore, the greater the ability of the debtor to service its debt, the greater is the expectation of repayment of the subordinated debt. While the subordination provision is inactive, the debtor may reduce the superior debt, increase the insulating assets, or even redeem the subordinated security altogether.

The second factor is the ability of the debtor to reduce superior debt in relation to the insulating assets. By such a reduction, there is an increase in the possibility of there being some realization on the subordinated debt in a liquidation. If, for example, a very large superior debt has been consistently and substantially reduced, the amount of claims which are prior to the subordinated securities is lessened, and the expectation of repayment on the subordinated security is increased. The reduction of the amount of superior debt may even reduce the tendency of complete subordination to indicate equity, if the reduction is such as to increase the possibility of there being no superior debt outstanding on the maturity date of the subordinated debt.

A third factor is the growth potential of the insulating assets in relation to the superior debt. This is, in effect, a corollary to the factor dealing with the reduction of the amount of a very large superior debt, and is also closely related to the earnings prospects of the business. The effect of a good asset growth potential is to increase the expectation of repayment.

Fourth, and interrelated with the previous three factors, is the factor

[27] In the second hypothetical case presented in note 24 supra, wherein there were $1000 in assets, $500 in subordinated obligations, and $750 in other obligations, only $500 of which were superior, it was noted that the "asset-liability" principle was inconclusive in the determination of whether the subordination indicates debt or equity. However, the "all-less than all" principle will be helpful, since the court should find that an instrument which is subordinated to less than all other obligations will be less risky than an instrument which is subordinated to all other obligations. A lesser risk and a greater certainty of repayment should, of course, be an indication of indebtedness rather than equity.

of present earnings and future prospects.[28] The present-earnings figure is important as an indication of the ability of the debtor to service its immediate obligations and to avoid default. When the subordinated securities have long-term maturity dates, a factor which evidences equity, future prospects should be evaluated in order to determine whether such prospects outweigh the evidence of equity. Likewise, if there is a large amount of superior obligations outstanding, and the present earnings and future prospects are good, it may be reasonable to expect that the subordinated security will be repaid.

Finally, there are two other factors which would tend to reduce the risk of the subordinated securities and thus increase the expectation of repayment: (1) a provision limiting the total amount of superior debt that may be incurred; and (2) a provision allowing subordination only to presently existing claims rather than to future claims as well. If, for example, at the time of the creation of the instrument, there are enough assets to insulate the subordinated as well as the superior claims, and neither of these two protective provisions are incorporated into the agreement, the debtor is free to incur an unlimited amount of superior obligations to an unlimited number of future creditors, with the result that an initially secure investment may be transformed into a risky one. Thus, the omission of at least one of these provisions should be considered a strong indication of an equity investment.

As an example of how the general principles interrelate with the several factors just presented, assume a case where the debtor's assets are sufficient to cover only the superior obligations. If the case were to be decided on this fact alone, the decision, following the "asset-liability" principle, would be that the subordination provision indicates an equity investment. However, if a steady history of debt servicing and reduction of the superior debt is introduced, as well as an optimistic prediction of future prospects, and if there is a limitation on the amount of superior debt that can be incurred, there may well be a reasonable expectation of repayment of the subordinated securities and hence an indication of debt.

A final perspective from which the subordination provision should be analyzed is the character of the party or parties holding the subordinated security. The relevance of this factor rests upon the different attitude toward the subordinated security which can be expected from different classes of holders. A large shareholder holding a subordinated security will probably act differently than an outsider holding the same security. It is unlikely, for example, that a dominant shareholder would enforce his claim at maturity if the corporation would have to borrow to repay the debenture, or would have to be liquidated, or even if his action would merely impair the credit rating of the corporation.[29] Indeed, enforcement by a stockholder-creditor in such

[28] The taxpayer in the instant case strenuously urged that its earnings record justified the finding that there was a reasonable expectation of repayment. Brief for Appellee, pp. 14-15. The dissenting judge thought that these earnings figures were significant. 367 F.2d at 989 n.3. Several other cases have stressed the importance of earnings figures. See, e.g., Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962); Esrenco Truck Co., 22 CCH Tax Ct. Mem. 287, 298 (1963).

[29] In Gooding Amusement Co., 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957), the leading case on this point, the maturity date had arrived, and the controlling stockholder had granted an extention. The stockholder frankly

a case "would not be in conformity with reason or sane business practice since it would be injurious and detrimental to himself as holder of the common stock."[30] As the identity of interest between the shareholders and debenture holders diminishes, however, the likelihood of an earnest intention to enforce increases, and enforcement on the maturity date or on default becomes more probable.[31] In short, the holder becomes more likely to act like a creditor.

It is now appropriate to fit the instant case within the foregoing analysis. Unfortunately, no evidence was introduced by either party concerning the actual amount of superior securities or insulating assets. Thus, the "asset-liability" principle cannot be utilized as an indicator; the "all-less than all" principle must be used in its stead. The debenture in the instant case expressly provided that it was to be subordinated to all obligations of the company. Therefore, according to that latter principle, the subordination provision would indicate equity. Few factors were introduced which might rebut that indication and aid the taxpayer in showing that the security represented indebtedness. There was no showing of any reduction in the amount of the superior debt; nor was there a showing of the growth potential of the insulating assets. The ability of the debtor to service its debt was not demonstrated, although the interest on the subordinated securities was paid promptly. In view of the twenty-year maturity date, evidence concerning the future prospects of the business would have been very important as an indication of the reasonable expectations of repayment. Unfortunately, no evidence of future prospects was introduced. Note also that there was neither a limit upon the amount of superior debt that could be incurred, nor subordination to present indebtedness only. Thus, there was the possibility that even if the amount of the superior securities was at one time low in relation to assets, there could be a subsequent incurrence of superior debt which would decrease the subordinated instrument's expectation of repayment. More important is the fact that the holders of the subordinated security were also the sole stockholders of this family corporation—a factor which would make the intent to enforce questionable.

The substantial nature of the taxpayer's present earnings was introduced, and, insofar as it indicated that the taxpayer's present obligations were being adequately serviced, it was a favorable factor in support of the taxpayer's claim that the security represented indebtedness. However, it does not appear

admitted that he would not enforce the obligation if it would be detrimental to the corporation. Notwithstanding the fact that the instrument on its face had all the earmarks of debt, the court stated:

> It is, in our opinion, unreasonable to ascribe to the [noteholders-shareholders] . . . an intention *at the time of the issuance of the notes* ever to enforce payment . . . . If the state of mind of the noteholders was [not to enforce at date of issuance] . . . , it is apparent that their position with respect to the amount represented by the principal of the notes was akin to that of the ordinary shareholder . . . . (Emphasis added.)

Id. at 418-19. A later case modified this apparently irrebuttable presumption drawn from the stockholder-creditor relationship, and expressed a willingness to consider rebuttal evidence on the issue of intent to enforce. Estate of Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956), reversing 24 T.C. 923 (1955).

30 Schneider Lumber Co., supra note 26, at 123.

31 See Charles E. Curry, 43 T.C. 667 (1965).

that present earnings alone would be enough to outweigh the "all-less than all" principle and the factors which have been shown to reinforce that principle. In this case, the reasonable expectation of repayment was not increased, and in fact may even have been decreased, which reinforces the indication that the subordination represented an equity investment.

In conclusion, it is submitted that when dealing with hybrid securities containing subordination, courts should attempt to analyze the subordination provision in terms of its effect upon the risk of repayment as that factor is related to the temporary-permanent dichotomy of debt and equity. The instant case reached the right result but failed to provide a satisfactory supporting analysis. All relevant factors making up the total fact pattern must be weighed before a decision on risk of repayment can be made. In order to be able to weigh the factors properly, evidence on total superior debt, future business prospects, and debt-servicing habits must be introduced. The issue of the relationship between subordination and the debt-equity question should not be decided by generalities.

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