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COMMENTS

THIN INCORPORATION: A CONTINUING PROBLEM

I. Introduction

One of the most difficult problems for a corporation which borrows money from its stockholders is an Internal Revenue Service claim that the corporation is "thinly capitalized." If this claim succeeds, the purported loans are treated as capital contributions for tax purposes, with the result that the corporation cannot deduct the "interest" payments and its repayments of principal are treated as dividends to the stockholders. Under the "thin corporation" rule, it is immaterial that the parties created an obligation which has all the legal incidents of a debt; the obligation is treated as capital regardless, merely because of the shareholder relationship of the creditor, the ratio of debt to capital, the use of borrowed funds by the corporation, and the other factors discussed below. Furthermore, since the government's claim that equity, rather than debt, has been created may not be asserted for a number of years, the parties may not become aware of this serious tax problem until after the notes or other purported debt instruments have been retired and the damage has been irreparably done. Thus, the importance of advance planning in this area cannot be overemphasized.

The possibility of this problem now exists in any type of corporate financing which involves advances from shareholders, whether at time of incorporation or afterward. The underlying question in all "debt vs. equity" cases is: Which type of security does the corporation's obligation most nearly resemble? Although the problem is not uncommon, it is not expressly covered by any section of the Internal Revenue Code or the Treasury Regulations.

A. Effect of Debt Rather Than Equity

Both the corporation and its stockholders may derive tax benefits from having stockholder contributions treated as debt rather than capital. Some of the major tax incentives are as follows:

1. If the transaction is treated as debt, recovery of the investment will not be treated as a dividend. Repayment of a loan will not usually create adverse tax consequences, but stock redemption often will.

2. Even if the basis of his debt securities is less than their face amount, the holder may be eligible for capital gain treatment upon retirement of the debt, under section 1232(a)(1) of the Internal Revenue Code or upon sale or exchange with outside parties.

3. If the venture fails, the holder will be able to claim a bad debt reduction; however, the stockholder may derive benefits superior to those of holding indebtedness if he has stock that qualifies under section 1244 instead.

4. The corporation may deduct interest paid or accrued on its indebtedness.[1] Dividends paid would not be deductible. The recipient of the payment is taxed whether it is interest or dividend, except that individuals may exclude $100 of dividends received each year[2] and corporations may deduct 85% of dividends received.[3]

5. Accumulation of the corporation's earnings to repay bona fide debt will usually be considered to be a reasonable need of the business, whereas accumulation to redeem stock may create problems with respect to the accumulated earnings tax.[4]

6. If the purported debt obligations are reclassified as capital contributions and if they are held by the stockholders in substantially the same proportion as they own stock, they may be treated as a second class of stock which would prevent the corporation and its stockholders from electing Subchapter S status.[5]

In addition to these common situations, various special problems of debt vs. equity occasionally arise.[6]

B. History

Thin corporation problems arose because of the taxpayer's desire to derive the maximum tax advantages possible from corporate indebtedness, while suffering as few disadvantages as necessary.

> Fixed debt obligations place a heavy financial burden upon a corporation: interest and principal must be paid despite corporate needs; a weaker financial position is presented; creditors and lending institutions are reluctant to advance funds to heavily indebted corporations. In turn, true lenders are not given special incentives, for they do not customarily participate in management nor share in the profits of the borrower.[7]

The taxpayer often attempted to solve his problem through various types of "hybrid" securities that contained some of the properties of both stocks and bonds; his ultimate purpose was to attain debt treatment for tax purposes and still retain some of the characteristics of equity for business purposes.

There have been numerous changes over the years concerning what constitutes a "thin" corporation. In 1941, the Fourth Circuit[8] disallowed

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[1] Int. Rev. Code of 1954, §163(a).
[2] Int. Rev. Code of 1954, §116(a).
[3] Int. Rev. Code of 1954, §243(a).
[4] Int. Rev. Code of 1954, §§531-537. See also: Pelton Steel Casting Co. v. Comm'r, 251 F.2d 278 (7th Cir. 1958); Mountain State Steel Foundries, Inc. v. Comm'r, 284 F.2d 737 (4th Cir. 1940).
[5] Treas. Reg. §1.1371-1(g) (1967).
[6] For a discussion of special problems including stockholder guaranteed loans, and sales to controlled corporations, see Aarons, *Debt v. Equity: Special Hazards In Setting Up The Corporate Capital Structure,* 23 J. Taxation (1965).
[7] Caplin, *The Caloric Count of a Thin Incorporation,* 43 MARQ. L. REV. 31 (1959).
[8] Brown-Rogers-Dixon Co. v. Comm'r, 122 F.2d 347 (4th Cir. 1941).

interest on "debenture preferred stock," holding that the title used by the taxpayers was not conclusive, but the circumstances were; the Court looked for a default provision, fixed maturity date, and due date, in determining whether debt or equity existed. In 1946, the Supreme Court in *John Kelley Co. v. Comm'r,*[9] held that no one factor controlled as to debt or equity, but several lower courts used dictum in the case to the effect that the relationship between stock investment and debt structure was highly relevant, and established the test of "debt to equity" as the major test. The Court had indicated that 4:1 was a "safe" ratio, but we know now that reliance solely on a low ratio is anything but safe. In *Gooding Amusement Co.,*[10] the Sixth Circuit appeared to view the "intent" of the parties in rejecting a formerly safe ratio of 1:1. On the other extreme, the Sixth Circuit has held a ratio of 18,800:1 acceptable.[11]

This constant shifting of perspective concerning the proper test to apply has led to the categorizing of the periods through 1959.[12]

Pre-1946: Hybrid Security Era—No one factor was paramount, but the primary issue was the real intention of the parties. Other factors which were stressed included variable interest and principal payments, voting rights, nomenclature, and subordination clauses.

1946-1956: Ratio Era—This was heralded by the *Kelley*[13] case.

1956-1959: Search For Substance—In *Gooding,*[14] interest was again viewed as a key factor.

The present era is as yet unnamed, but perhaps it could be called the "Confusion Era."

C. The Tests of Debt vs. Equity

Many different tests have been used by the courts to determine whether debt or whether equity exists. Some of the more common ones are: whether the "loans" are proportionate to shareholdings; whether they are subordinated to other debt; whether the terms are such as those an outside lender would not agree to; whether the business conditions are such that no outside lender would loan money to the business; whether repayment is at the risk of the business; the intent of the parties; and the ratio of debt to equity.

The courts have found various uses for these tests; while one particular court may find that only one test is controlling, another may prefer a different test or a combination of tests. The matter is further complicated by the fact that as general financial conditions change, the

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9 326 U.S. 521 (1946).
10 236 F.2d 159 (6th Cir. 1956).
11 Byerlite Corp. v. Williams, 286 F.2d 285 (6th Cir. 1960).
12 Caplin, *The Caloric Count of a Thin Incorporation,* 43 Marq. L. Rev. 31, 33 *et. seq.* (1959).
13 John Kelley Co. v. Comm'r, 326 U.S. 521 (1946).
14 Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (6th Cir. 1956).

test or tests used by any particular court may also change. Even where the parties' intent is deemed controlling, the courts are not in consonance as to which qualities indicate what the parties intended.[15]

Perhaps the most arbitrary and controversial test is ratio of debt to equity: if there is a high ratio of debt to the investment in capital stock, some, or usually all, stockholder owned debt is considered as equity investment. The ratio is based on actual rather than book values; the value of the stock may be based on paid-in capital plus retained earnings, or on arms length sales of the stock.[16] There is now substantial doubt concerning how low the ratio must be to be safe from attack; formerly 4:1 was believed safe, but the *Gooding*[17] case held that even a 1:1 ratio situation was subject to attack as investment rather than indebtedness.

II. How the Courts Approach the Problem

Since, as we have seen, the tests used are not uniform, and the Internal Revenue Code is no help, it will be necessary to examine the views of selected courts individually.

A. First Circuit

In *Gloucester Ice & Cold Storage Co. v. Comm'r,*[18] the First Circuit held that despite a 15:1 debt-equity ratio, an obligation is to be treated as debt rather than capital where it is not sham, it bears interest which is payable regardless of corporate earnings, it is valid on its face, and has good prospects of being paid when it becomes due. This suggests that the First Circuit stresses good faith and intent of the parties.

However, it has been suggested[19] that the Treasury, in an attempt to bar interest deductions, at least in the First Circuit, may be using an older case which barred an interest deduction on registered notes which a family corporation issued in exchange for 80% of its capital stock.[20]

B. Second Circuit

In *Kraft Foods Co. v. Comm'r,*[21] Kraft, a subsidiary of National Dairy with a stated capital of $2,000,000, declared a dividend of $30,-000,000 in 6% debentures with fixed maturity date and acceleration on

[15] For interesting cases relating to a successful claim by the Treasury that the parties did not intend to make a loan, see Fellinger v. United States, 363 F.2d 826 (6th Cir. 1966) and Hippodrome Building Co., T. C. Memo. 1965-25, see 4 RIA Tax Coordinator §K-5114.1 in which the editors believe that the former case is a threat to closely held corporations and to widely held corporations which sell bond-stock packages to buyers who primarily want the equity interest.

[16] 34 Am. Jur. 2d *Federal Taxation* §7133 (1967).

[17] Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (6th Cir. 1956).

[18] 298 F.2d 183 (1st Cir. 1962).

[19] 4 RIA Tax Coordinator *Developments* §K-5105.

[20] Talbot Mills v. Comm'r, 146 F.2d 809 (1st Cir. 1944).

[21] 232 F.2d 118 (2nd Cir. 1956). It should be noted that this is one of the few thin incorporation cases not involving a closely held corporation.

default, mainly to minimize taxes; the interest rate was later reduced to 4% and on the due date the debentures were replaced by similar 4% debentures. The Commissioner argued that the debt-equity ratio was excessive, that a parent-subsidiary relationship was involved, that there was no intent to create a debt, and that there was only a tax saving purpose but no business purpose. In a 2-1 decision, the Court allowed the interest deduction because the taxpayer's intention to create indebtedness was clearly manifested since the debentures had the attributes of debt. The majority found no policy reason to disregard the interest of the parties; thus, two corporations were allowed to minimize their taxes merely by showing an intention to create indebtedness, though no business purpose was shown.

The theory in the more recent *Gilbert*[22] case is much less clear, with the three judges expressing separate views. Though all of them found an intent to create debt, Judge Medina, who wrote the opinion, believed the controlling test was the "Risk" test: whether there was reasonable expectation of repayment irrespective of the success or failure of the venture. He found that six factors must be considered in using the test: the ratio of debt to equity, presence of tax avoidance motives, agreement to keep debt proportional to equity investment, use of the funds, whether outsiders would have made the investment, and lack of reasonable expectation of repayment.[23]

Judge Waterman, in a concurring opinion, found that even where there is an intent to create debt there are situations in which advances may not be considered loans.[24] He believed that two tests were important: (1) "Proportionate Holding" test: whether advances were made in proportion to the equity investments of the parties; and (2) whether advances had been continuously made without regard to normal creditor safeguards under the circumstances. The latter is rather similar to Judge Medina's test. Judge Hand dissented, believing that a finding of nontax reasons for the transaction is necessary to avoid equity treatment; this view has been termed the "Business Purpose" test.

Upon remand, the Tax Court again held that the advances did not qualify as bona fide debts for tax purposes, and supported its view with "findings of ultimate fact" which were sufficient to satisfy the tests promulgated by all three Second Circuit judges.[25] When the case was appealed again, the Second Circuit, with none of the judges present who had participated in the previous decision, affirmed.[26] It was concluded that no one element was determinative in deciding whether particular advances should be treated as equity rather than debt, but in this case:

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22 Gilbert v. Comm'r, 248 F.2d 399 (2nd Cir. 1957).
23 *Id.* at 406, 407.
24 *Id.* at 409, 410.
25 17 T.C.M. 29 (1958).
26 262 F.2d 512 (2d Cir. 1959).

(1) there was an attempt to keep advances closely proportionate to stockholdings, (2) Gilbert knew that the advances might be absorbed by the corporation's capital requirements, and (3) the advances were continued after the corporation was obviously in serious financial difficulty and unlikely to repay.

The Second Circuit dealt with this problem more recently in *Nasau Lens Co. v. Comm'r,*[27] and held that where the owner of a business transferred the business to a corporation in exchange for all the stock of the corporation pursuant to an agreement whereby the corporation issued debenture notes of $150,000 to the stockholder for $100,000 of assets, the corporation should not be deprived of a discount deduction in its tax computation, even though the stockholder had no business purpose.

> In absence of statutory language or legislative history to the contrary, the desire to save taxes is not by itself sufficient to use to disregard the form adopted by the taxpayer, for "the question for determination is whether what was done, apart from the tax motive was the thing which the statute intended.[28]

The court summarized its position:

> In short, we have held that non-arm's-length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's-length standards, not the extent to which the taxpayer has a business purpose. . . . There is "no rule which permits the Commissioner to dictate what portion of a corporation's operations should be provided for by equity financing rather than by debt," Estate of Miller v. Commissioner, 239 F.2d 729, 734 (9th Cir. 1956), so long as the latter can be said to be debt in terms of substantial economic reality.[29]

After finding whether a debt has in fact been created, the next step is to determine whether it should be treated as debt for tax purposes. The court found that this depends on "whether the creation of the debt had a result similar to the one Congress had in mind when it drafted the statute involved, or if the intent is left unclear, whether there is a patent distortion of normal business practice."[30] The standards to be applied are: (1) There must be an intent to repay, or no debt can exist; (2) To what extent do the debentures bear a substantial risk of the enterprise and are tied up with the success of the venture; (3) Whether they specify a date on which the creditor may demand a definite sum regardless of profits; (4) Whether the instrument is subordinated to debts held by outsiders; (5) Debt-Equity ratio; (6) Whether outsiders would have made similar advances; (7) Very high rate of interest or

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[27] 308 F.2d 39 (2d Cir. 1962).
[28] *Id.* at 44; citing Gregory v. Helvering, 293 U.S. 465, 469 (1935).
[29] *Id.* at 46.
[30] *Ibid.* For an application of the Court's statement relating to the intent of Congress, see J. T. Slocomb Co. v. Comm'r, 334 F.2d 269, 275 (2d Cir. 1964).

discount may indicate a dividend. Tax savings motives may be considered but are not conclusive.[31]

Thus, the Second Circuit presently appears to be searching for the manifested intent of the parties, and business purpose, or lack of it, is no more than evidence of what the parties intended.

C. Fifth Circuit

In *Rowan v. United States*,[32] the Fifth Circuit held that the "true intent" of the parties controlled, and while the intent is to be garnered from all the relevant facts and circumstances, the debt-equity ratio was considered not to be relevant. The court cited *Rowan* in rejecting the ratio in *Sun Properties v. United States*,[33] although there was a ratio of 310:1; in the latter decision, "business purpose" was also rejected.[34]

The court, in *United States v. Snyder Brothers Co.*,[35] found that where $450,000 book value of partnership assets were transferred to a corporation which assumed $203,000 of partnership liabilities and gave the partners $100,000 of par value stock and $140,000 of debentures which were subordinated to all indebtedness of the corporation, matured in 20 years, and paid 6% interest, the debentures were not real debts. It was noted that when all of the circumstances were considered together, there was little difference the debentures and preferred stock: (1) The "debt" was between a corporation and its stockholders; (2) The debentures were subordinated; (3) The debentures were extremely long term (20 years) and unsecured; (4) There was no limitation on the amount of payment of the dividends and no provision for a sinking fund out of which payments can be reasonably assured after all other obligations are paid. The court also emphasized that while subordination alone does not prevent creation of a debt, and while a stockholder may also be a creditor of his corporation, both of these occurrances were present in this case.

In *Tomlinson v. 1661 Corp.*,[36] the Fifth Circuit apparently reaffirmed the rejection of the debt-equity ratio, although it was also stated that it was uncertain to what extent the ratio remained a pertinent consideration in the circuit. It was further held that if the corporation needed money which outsiders would only lend it on terms the corporation considered "economically unwise," it could borrow funds from its stockholders without having the debt classified as capital. The court also limited its earlier stand against subordination; it distinguished this case, in which the debt was subordinated only to a mortgage, from the

[31] "In short, a departure from normal business patterns combined with a tax avoidance motive usually will be sufficient to justify treating the 'loan' as equity. Either factor alone, however, is not enough." *Id.* at 47.
[32] 219 F.2d 51 (5th Cir. 1955).
[33] 220 F.2d 171 (5th Cir. 1955).
[34] *Id.* at 174-175.
[35] 367 F.2d 980 (5th Cir. 1966).
[36] 377 F.2d 291, 296, 298-299 (5th Cir. 1967).

Snyder case, in which the debentures were subordinated to all present and future indebtedness. Finally, the court concluded that the ultimate question to be decided is not the intent of the parties, but rather whether their intent should be recognized for tax purposes; therefore, intent cannot be the "sole consideration."[37]

D. Sixth Circuit

The Sixth Circuit approach appears similar to that of the Fifth.

In *Byerlite Corp. v. Williams,*[38] it was held that the transaction should be accorded the treatment that the parties intended, and that business risk is not a useful test because anyone who makes a loan to a corporation takes a risk. But in *Foresun,*[39] the court found no debt where there was: (1) "high" ratio of debt to equity (100-1); (2) no payment of principal on the note; and (3) subordination of the note to a new bank loan; therefore, a transfer of land to the corporation for a note and cash was a capital contribution even though the grantor owned no stock in the corporation.

The Sixth Circuit found a "classic" case of capital contributions disguised as loans in *Jones v. Comm'r.*[40] The taxpayer inherited stock in a family corporation and made advances to help it pay expenses, receiving in exchange unsecured notes which were subordinated to all of the corporation's other debts. All but one note bore no interest (and none was paid on that one), none had a maturity date, and the taxpayer, most significantly, expected repayment from the proceeds of a possible sale of the corporation's assets. The attempted bad debt deduction was disallowed.

E. Seventh Circuit

In *Sarkes Tarzian v. United States,*[41] the Seventh Circuit indicated that the primary consideration was the intent of the parties under all of the relevant circumstances. Thus, the ratio test was impliedly diluted.

In 1959, several considerations were combined to defeat the taxpayer's attempt to receive debt treatment. The court, in *Arlington Park Jockey Club v. Sauber,*[42] noted that various factors had been stressed

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[37] *Id.* at 299. The Court cited the eleven factors in determination of debt or equity of O. H. Kruse Grain & Milling Co. v. Comm'r, 279 F.2d 123, 125 (9th Cir. 1960) with apparent approval: (1) Names given to the certificates of obligation; (2) presence or absence of maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (5) participation in management; (6) status equal to or inferior to that of regular corporate creditors; (7) intent of the parties; (8) thin or adequate capitalization; (9) identity of interest between creditors and stockholder; (10) payment of interest only out of "dividend" money; (11) ability of the corporation to obtain loans from outside landing institutions. Other criteria are also possible. *Id.* at 296.

[38] 286 F.2d 285 (6th Cir. 1960).

[39] Foresun, Inc. v. Comm'r, 348 F.2d 1006 (6th Cir. 1965).

[40] 357 F.2d 644 (6th Cir. 1966).

[41] 240 F.2d 467, 470 (7th Cir. 1957).

[42] 262 F.2d 902 (7th Cir. 1959).

in determining whether advances to closely held corporations are loans for tax purposes: (1) Debt-equity ratio; (2) Use to which the funds were put; (3) Whether outside investors would make such investments; and (4) Lack of reasonable expectation of repayment. The advances were found to be contributions to capital because: (1) They were at the risk of the venture, and subordinate to the claims of creditors; (2) They were in direct proportion to stockholder ownership, and this gives rise to strong inference of capital investment; and (3) There was no fixed maturity date.

The Seventh Circuit dealt with the problem more recently in the *Charter Wire*[43] case. There, stockholders in the defendant corporation had originally begun as a partnership, but had subsequently transferred the partnership assets to defendant for book value ($66,805.74) in notes, and each former partner purchased stock, aggragating $680, in exact proportion to the notes he held; when a new executive was hired, he was allowed to purchase stock, but he was also required to loan money to the corporation. The notes were subordinated to a bank held debt, and interest was paid regularly on the notes except during a three month period in which the corporation had a tight cash position. The "loans" were held to constitute capital contribution, so that its "interest" payments were treated as dividends and were not deductible.

The court found a strong inference prevailed that the obligations were capital, because the stockholders always held their notes in direct proportion to their equity. Another factor which weighed in favor of the United States was that the assets for which the notes were exchanged were essential to the conduct of the corporation's business. Although the court agreed that the taxpayer had a very favorable debt-equity ratio, it cited approvingly a First Circuit[44] case stating that the absence of an unfavorable ratio was not controlling. The Seventh Circuit also agreed with the First Circuit decision[45] that since expectation of payment at maturity is a good indication of existance of debt, a sinking fund should be established to provide for retirement of debt obligations.

F. NINTH CIRCUIT

As early as 1952,[46] the Ninth Circuit expounded the view that the validity of debt depended on the intent of the parties, and that, for this purpose, evidence of business purpose was more important than the ratio. This view concerning the debt-equity was reaffirmed in *Miller's Estate v. Comm'r*,[47] in 1956.

In *Lundgren v. Comm'r*,[48] the court stated that even if there had

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[43] Charter Wise, Inc. v. United States, 309 F.2d 878 (7th Cir. 1962).
[44] Brake & Electric Sales Corp. v. United States, 287 F.2d 426 (1st Cir. 1961).
[45] Gloucester Ice & Cold Storage Co. v. Comm'r, 298 F.2d 183 (1st Cir. 1961).
[46] Earle v. W. J. Jones & Son, Inc., 200 F.2d 846 (9th Cir. 1952).
[47] 239 F.2d 729, 734 (9th Cir. 1956).
[48] Lundgren v. Comm'r, 376 F.2d 623 (9th Cir. 1967).

been no equity and the advances were entirely at the risk of the business, the loan could still be valid. It was evidenced by promisory notes bearing interest which were subordinated to an SBA loan but not to any other debt; also, Lundgren's voting power in the corporation had not been changed. The obligations were deemed to be loans, and the fact that outside sources would not have made advances and that the advances were partially subordinated was held not, of themselves, controlling.

The Ninth Circuit recently held for the taxpayers in a rather unusual case.[49] Three partners with a solid reputation and connections in the logging business sold the partnership assets to a new corporation; each partner purchased $1,500 worth of stock and the corporation borrowed $240,000 to buy the assets, the partners having guaranteed the note. Apparently, one of the motives for incorporating was to get a new tax basis on the machinery and to begin depreciating it again. Internal Revenue, claiming the transaction should be a tax free exchange, disallowed the stepped-up depreciation basis, and held that the payment for the assets with money borrowed from the bank was a constructive dividend to the stockholders (formerly partners). The court found that because the stockholders were well known men of integrity in the logging business, their established position in the industry was of sufficient value to the corporation to prevent the venture from being thinly capitalized. This holding should be of little consolation to stockholders who seek to avoid attack by guaranteeing loans rather than actually loaning the money themselves, for the court pointed out that when taxpayers use pure gimmicks of form to shield the real essence of the transaction, the transaction will be recast for tax purposes.

III. CONCLUSION

We have seen that capitalizing a corporation with debt obligations instead of stock is usually advantageous to both the corporation and the stockholder, for the reasons discussed above. It may be especially tempting for persons about to incorporate a business to attempt to do so partly by issuing debt obligations. If the classification of debt is not challenged, the incorporators may derive not only a tax free incorporation[50] but also all the advantages of receiving some debt instruments rather than only stock certificates. While that result is desirable, there is a risk that the debt obligations will be treated as capital contributions if their duration is long[51] (in which case the tax free incorporation is still preserved), or as "other property"[52] if their duration is not suffi-

[49] Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967).
[50] Int. Rev. Code of 1954, §351.
[51] One of the circumstances that the Fifth Circuit found weighing against debt treatment was that the debentures were of extremely long duration (20 years). United States v. Snyder Bros. Co., 367 F.2d 980 (5th Cir. 1966).
[52] Int. Rev. Code of 1954, §351(b), Also see Turner v. Comm'r, 20 T.C.M. 468 (1961), holding that a relatively short term note is not of sufficient duration to be a "security" under §351.

ciently long for them to be classified as "securities." If they are neither stock nor securities, the incorporation is partially taxable.[53]

In addition to the possible loss of tax free incorporation, the taxpayers also risk their opportunities for Subchapter S status if they classify advances to the corporation as loans. If the government is successful in having the advances reclassified as capital contribution, there is great risk that the reclassified equity will be held to constitute a second class of stock, unless it is held in substantially the same proportion as the "creditor's" stockholdings;[54] if a corporation has more than one class of stock, it may not elect Subchapter S status.[55] While proportionate "debt" to stockholdings will save Subchapter S treatment, it will almost certainly result in all advances by stockholders being reclassified as capital contributions. This anomoly leaves the taxpayer in a seemingly irreconcilable position, and is of great concern at the planning level.

The debt-equity enigma has had a stormy and confusing existence. During the period of hybrid securities, the courts used a simple approach: the form of the instrument determined whether it was stock or indebtedness. This was followed by the prominence of the ratio of debt to equity as the sole test.[56] Since the end of the ratio test as the ultimate test,[57] we have been in a never-never land. The courts have wrestled with theories relating to proportionate holdings of debt and stock, intent of the parties, and risk; yet no real answer has emerged.

When a stockholder holds debt and stock proportionately, his claim that debt treatment should be accorded is weakened because the advances appear to be stock. Presently, proportionate holdings is a factor that the courts will consider, but it is not the sole criterion. Unfortunately for the taxpayer, disproportionate holding of debt and equity does not guarantee debt treatment.[58]

"Intent" and "risk" are also factors a court may consider. In *Gooding*,[59] advances were held to be equity where they had long since matured but no payment had been made; thus the taxpayer did not act as a creditor would, because he took no steps to enforce repayment. The Second Circuit, in the *Nasau Lens case*,[60] held that intent to repay is necessary in order to establish indebtedness; also, the court should consider whether repayment is tied to the success of the business, and is, therefore, at the risk of the business.

It is easily seen that there is a great lack of uniformity among the

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[53] Int. Rev. Code of 1954, §§351(a), (b).
[54] Treas. Reg. §1.1371-1(g) (1967).
[55] Int. Rev. Code of 1954, §1371(a)(4).
[56] John Kelley Co. v. Comm'r, 326 U.S. 521 (1946).
[57] Rowan v. United States, 219 F.2d 51 (5th Cir. 1955).
[58] Reed v. Comm'r, 242 F.2d 334 (2d Cir. 1957).
[59] Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (6th Cir. 1956).
[60] Nasau Lens Co. v. Comm'r, 308 F.2d 39, 47 (2d Cir. 1962). Also see Judge Medina's opinion in Gilbert v. Comm'r, 248 F.2d 399 (2d Cir. 1957).

circuits.[61] The views of individual jurisdictions range from rather liberal (from the taxpayer's point of view) to highly government-oriented. Perhaps most confusing is the propensity of courts which pay lip service to the same "test" to apply different criteria, or the same criteria in different ways, in reaching their conclusions.

Probably the most important step the taxpayer can take toward convincing a court that the advances he made should be accorded debt status, is that either the indebtedness was repaid in accordance with its terms, or that there is a date set for its reitrement in the formal written agreement, interest is being periodically paid in the meantime, and repayment is being assured by a trusteed sinking fund to which payments are made by the corporation irrespective of corporate earnings. While there is a great difference of opinion concerning which tests should be given the most weight, three generalities appear to have emerged from the maze of court decisions: (1) Although many circuits purport to discredit the debt-equity ratio, most of them at least consider the ratio to be one of the important factors in determining the intent of the parties; thus, the ratio is far from dead. (2) While the parties may be able to subordinate stockholder held obligations to some outside debt, a combination of complete subordination and a high debt-equity ratio would probably prove fatal to a claim of indebtedness; the importance of subordination has been adequately demonstrated in the Fifth Circuit, where completely subordinated debentures were found to be equity[62] while advances subordinated only to a mortgage were allowed to be treated as indebtedness.[63] (3) There is some authority for the proposition that business purpose is no longer required, although it is one of the things a court will probably consider.[64] While these are the most important criteria, the court may also consider the name given to the certificates of obligation, whether dividend payments would be restricted if interest payments become in arrears, and whether the corporation could have obtained loans from an outside lending institution. Even casting the transaction as a guarantee of a bank loan rather than an actual loan by the stockholder is not likely to help,[65] if the court's "tests" are not met.

At the planning stage, only one other suggestion can be made to the taxpayer. While no ratio can be considered "safe" any longer, a very low ratio of debt to equity may yield considerable tax benefits while

[61] Hickman, *The Thin Corporation: Another Look at an Old Disease,* 44 Taxes 883, 885 (1966). The author reported that between 1963 and early 1966, the issue of thinness had been dealt with by: Tax Court, 43 times (taxpayers won fifteen); Court of Claims, once (taxpayer lost); Federal District Courts, 24 times (taxpayers won fifteen); Courts of Appeal (taxpayers won only two of thirteen decisions).
[62] United States v. Snyder Bros. Co., 367 F.2d 980 (5th Cir. 1966).
[63] Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967).
[64] Nasau Lens Co. v. Comm'r, 308 F.2d 39, 47 (2d Cir. 1962).
[65] Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967).

keeping the possibility of challenge by the government comparatively low. In other words, having the benefit of part of the investment being treated as debt rather than equity is better than having no such benefit at all.

The only thing which is now clear is that the various courts have created a great patchwork of rules that can best be untangled by Congress. In reviewing the myriad of tests used, one can hardly help but think:

> Perhaps the judicial ruminations can be summarized, without disrespect or loss of clarity, by saying that they come down to a standard that becomes instinctive with the experienced lawyer in this, as in many other areas: the "pig" theory, so named after the Wall Street adage that "You can make money being a bull, and you can make money being a bear; but you can't make money being a pig."[66]

MARTIN J. KURZER

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[66] BITKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, §4.04 (2d Ed. 1966).