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THE CALORIC COUNT OF A THIN INCORPORATION*

MORTIMER CAPLIN**

INTRODUCTION

This is an oft-told tale. Yet, because of the frequency of its recurrence in practice and in the courts, it merits reexamination. A judicial muddle has currently developed in handling thin incorporation and corrective legislation is anticipated in the very near future.

Definition.

"Thin incorporation," in its original form, related to those “extreme situations such as nominal stock investments and an obviously excessive debt structure." In the evolution of this concept, however, its meaning has broadened. Today, when we refer to “thin incorporation,” we usually are seeking to resolve one single factor: the extent to which stockholder-loans may be used to finance a corporation. A material stock investment, or a debt structure not “obviously excessive,” no longer is deemed to obviate the issue. For as the administrators and judiciary now view the matter, the problem lurks in any corporate financing dependent in part on advances from stockholders.

Tax Incentive for “Thinning.”

Both stockholder and corporation have tax incentives for “thinning” the capital structure.

Stockholder Principal Advantages:

First, and foremost. Indebtedness provides the stockholder with a means for recouping his investment free of the dividend threat. Repayment of his “loan” normally will not bring adverse tax consequences; redemption of his stock often will. If he seeks to recapture funds by redemption, he runs serious risk of its being found “essentially equivalent to a dividend” —unless he can meet the demanding standards of Code Section 302(a) and (b).

Second. Even if the basis of his debt securities is less than their face amount, he will have capital gain potential through retirement of the debt, or sale or exchange with outside parties. All that has to be

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1 John Kelley Co. v. Com'r, 326 U.S. 521, 526 (1946).
2 Consider Judge Medina's use of the word "or" instead of "and" in referring to (a) nominal stock investments and (b) obviously excessive debt structure. Gilbert v. Com'r, 248 F. 2d 399, 407 (2d Cir. 1957).
3 Cf. INT. REV. CODE OF 1954, §302(b)(1).
4 INT. REV. CODE OF 1954, §1232(a)(1).
avoided here is the "original issue discount" exception of Code Section 1232(a)(2).

Third. He will be able to claim a bad debt deduction if the venture fails. This may be of only limited utility, for his deduction will usually be a short-term capital loss for non-business bad debts.\(^5\) In contrast, if he can establish that he is in the business of promoting or lending,\(^6\) or can show that the loan was proximately related to another separate business of his own,\(^7\) he will be able to take full advantage of the deduction for worthless or partially worthless business bad debts.

Fourth. Holding debt securities will lay a foundation for his tax-free participation in later debt refinancing of the corporation. Since 1954, issuance of debt securities in a recapitalization or other reorganization may automatically produce taxable "boot."\(^8\) But this will not result if the principal amount of securities received does not exceed the principal amount of securities surrendered. While this may not be of major importance to the stockholder, it is a make-weight in favor of using debt securities.

*Corporation chief advantages:*

*First.* The corporation may deduct "interest" paid or accrued on outstanding indebtedness.\(^9\) This avoids the curse of "double taxation" of corporate profits. Dividends, of course, would not be deductible in computing its taxable income. At the same time, by receiving interest in lieu of dividends the individual stockholder forfeits the benefits of the exclusion and credit for dividends received,\(^10\) while the corporate stockholder loses the valuable 85% dividends received deduction.\(^11\)

*Second.* The corporation may procure a step-up in basis on receiving appreciated property in exchange for short-term debt or contract obligations. By issuing evidence of indebtedness maturing in, say, four years or less, the corporation should be outside the definition of "securities" contained in Code Section 351 and should thereby have attained a taxable transfer.\(^12\) The transferor-stockholder, how-

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\(^6\) Giblin v. Com'r, 227 F. 2d 692 (5th Cir. 1956).


\(^9\) INT. REV. CODE OF 1954, §163.


\(^12\) *Cf.* Rev. Rul. 56-303, 1956-2 CUM. BULL. 193 ; Lloyd-Smith v. Com'r, 116 F. 2d 642 (2d Cir. 1941) ; John W. Harrison, 24 TC 46 (1955), aff'd, 235 F. 2d 587 (8th Cir. 1956), cert. den., 352 U.S. 952 (1956).
ever, should make sure he is not subject to ordinary income treatment under Code Section 1239.

Third. By issuing debt obligations rather than stock, a corporation provides itself with a possible defense against the unreasonable accumulations surtax. Organized as a "poor" entity, heavily loaded with debt, a corporation has sometimes been able to justify accumulations of earnings and profits. To be sure, this is not an absolute defense, and it was recently discarded in Smoot Sand & Gravel Corporation in the light of an initial 200 to 1 debt-equity ratio.

**Genesis of the Problem.**

The "thin incorporation" problem had its genesis in taxpayer's desire to employ corporate indebtedness for procuring all its tax advantages but avoiding most of its substantive disadvantages. 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 profits of the borrower.

As a solution to this dilemma, taxpayer and his counsel experimented with a wide variety of hybrid securities—"a 'security device' which is in truth neither stock nor bond, but the half breed offspring of both." These instruments were brought to the fore in the hope of attaining "debt" status for tax purposes and, at the same time, retaining sufficient characteristics of equity for business and corporate financing purposes. Taxpayer strove to have his cake and to eat it too.

To meet the gyrations of counsel working under a simple provision of the tax statute, courts experimented with a variety of theories to prevent what seemed to be blatant tax avoidance.

From a broad point of view, the history of "thin incorporation" may be divided into three major periods:

*Pre-1946:* struggle with hybrid securities;

*1946-1956:* reliance upon ratios;

*1956-to date:* decline of ratio test and search for "substance."

Like all classifications, there is a measure of arbitrariness in this one. But it has its justification. Prior to 1946, we find courts concentrating on the intent of the parties; from the 1946 Supreme Court decision, *John Kelley Co.*, to the 1956 Court of Appeals ruling in

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15 John Kelley Co. v. Com'r, 326 U.S. 521, 535 (1946). Also, see Com'r v. H. P. Hood & Sons, 141 F. 2d 467, 469 (1st Cir. 1944) ("overlapping characteristics").
the Gooding case,\textsuperscript{17} decisions lean heavily on the objective standard of the ratio between debt and equity; following Gooding, we see a shift in emphasis—less reliance upon ratios, and a search for bona fides, genuineness and "substance."

Also, in viewing decisions historically, we must recognize the existence of a lag in lower court rulings. Not all cases immediately following John Kelly Co. sharply shift to the ratio test; nor do all decisions following Gooding indicate a clean break with the debt-equity analysis. However, a broad sampling of the cases confirms the existence of the trends suggested.

**HYBRID SECURITY ERA (pre-1946)**

**Judicial Procedures Originally Followed.**

In the series of cases before John Kelly Co. v. Commissioner, the Tax Court and Courts of Appeals examined many variations of hybrid securities.\textsuperscript{18} The four corners of the instrument would be carefully scrutinized, corporate records scanned for consistency, and the conduct of the parties considered. All evidence would be carefully weighed in the procedure for reaching the crucial finding. In a large measure, the judicial process at this time involved "a minute comparison of, and effort to differentiate, . . . multitudinous microscopic details."\textsuperscript{19}

**Importance of Instrument.**

Primary emphasis was placed upon the terms set forth in the corporate documents: nomenclature; variable interest payments; variable principal payments; voting rights; subordination clauses; and, generally, intent of the parties. As Judge Turner stated in the Tax Court in John Kelley Co.:\textsuperscript{20}

The determining factors are usually listed as the name given to the certificates, the presence or absence of maturity date, the source of the payments, the rights to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties.

**Primary Issue: "Real Intention."**

No one factor was controlling. But, in the last analysis, the primary issue was the "real intention of the parties."\textsuperscript{21}

\textsuperscript{17} Gooding Amusement Co. v. Com'r, 236 F. 2d 159 (6th Cir. 1956), aff'g 23 TC 408 (1954).

\textsuperscript{18} E.g., First Mortgage Corp. v. Com'r, 135 F. 2d 121 (3d Cir. 1943); United States v. Title Guarantee & Trust Co., 133 F. 2d 990 (6th Cir. 1943); Com'r v. Meridian & Thirteenth Realty Co., 132 F. 2d 611 (7th Cir. 1940). See Uhlman, *The Law of Hybrid Securities*, 23 Wash. L. Q. 182, 205-7 (1928).

\textsuperscript{19} John Kelley Co. v. Com'r, 326 U.S. 521, 532 (1946).

\textsuperscript{20} John Kelley Co., 1 TC 487, 462 (1943), rev'd, 146 F. 2d 466 (7th Cir. 1944), rev'd, 326 U.S. 521 (1946).

\textsuperscript{21} Com'r v. Meridian & Thirteenth Realty Co., 132 F. 2d 182, 184 (7th Cir. 1946).
Throughout this period, taxpayer seems to have had the better part of the argument. Litigation usually involved the deductibility of "interest" and, in a good percentage of the cases, taxpayer carried the burden of proof. Ultimately, all the corporation had to prove was that it intended to issue a debt security. And this might be possible even though the instrument bore the telling label of "preferred stock."21a

Relevance of Debt-Equity Ratio.

During most of this stage, hardly any attention was paid to the ratio between indebtedness and net worth. Some rather extreme debt-equity ratios were approved without comment.22

Yet, hints of things to come are found in the pre-1946 Tax Court cases of Edward G. Janeway,23 Michael Cohen24 and 1432 Broadway Corporation.25 Although, in the 1946 case of Cleveland Adolph Mayer Realty Corporation,26 the Tax Court seems to have backtracked when it distinguished 1432 Broadway Corporation on traditional grounds of examining all the terms of the governing instrument.27

AGE OF RATIOS (1946-1956)

Dictum in Kelley Case.

The age of ratios was introduced by the Supreme Court dictum in John Kelley Co. v. Commissioner.28 There, the Court had the difficult task of reconciling the irreconcilable—the conflicting Tax Court decisions of John Kelley Co.29 (in favor of the taxpayer) and Talbot Mills30 (in favor of the Commissioner). The securities in both cases were hybrids, with only microscopic distinctions. Nevertheless, over

1942); Com'r v. Proctor Shop, Inc., 82 F. 2d 792, 794 (9th Cir. 1936), aff'd, 30 BTA 721, 725 (1934). See Gooding Amusement Co., 23 TC 408, 418 (1954), aff'd, 236 F. 2d 159 (6th Cir. 1956).

21a United States v. Title Guarantee & Trust Co., 133 F. 2d 990 (6th Cir. 1943). Also, compare Bowersock Mills & Power Co. v. Com'r, 172 F. 2d 904 (10th Cir. 1949), and Choctaw, Inc., 12 TCM 1393 (1953), with Crown Iron Works Co. v. Com'r, 245 F. 2d 357 (8th Cir. 1957).

22 150,000 :1 ($750,000 :$5) in 250 Hudson St. Corp., 5 TCM 722 (1946). Also, see Glenmore Distilleries Co., 47 BTA 213 (1942) (131:1), acc.; Edward Katzinger Co. v. Com'r, 129 F. 2d 74 (7th Cir. 1942) (64:1); Com'r v. O.P.P. Holding Corp., 76 F. 2d 11 (2d Cir. 1935) (25:1); Clyde Bacon, Inc., 4 TC 1107 (1945) (9:1), acc.

23 2 TC 197 (1943), aff'd, 147 F. 2d 602 (2d Cir. 1945).

24 3 TCM 236 (1944), aff'd, 148 F. 2d 336 (2d Cir. 1945).

25 4 TC 1158 (1945), aff'd, 160 F. 2d 885 (2d Cir. 1947).

26 6 TC 730 (1946), rev'd on other grounds, 160 F. 2d 1012 (6th Cir. 1947), on remand, 8 TC 1163 (1947).


29 1 TC 457 (1943), rev'd, 146 F. 2d 466 (7th Cir. 1944), rev'd, 326 U.S. 521 (1946).

30 3 TC 95 (1944), aff'd, 146 F. 2d 809 (1st Cir. 1944), aff'd, 326 U.S. 521 (1946).
the vigorous dissent of Mr. Justice Rutledge, the majority swiftly cut the Gordian knot using as its sword, *Dobson v. Commissioner.*

In finding support for the Tax Court's evidentiary and ultimate findings of fact in both cases, the majority reiterated the well-established doctrine that "no one characteristic, not even exclusion from management, . . . can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts." But, in an earlier dictum in the opinion, Mr. Justice Reed opened the floodgates when he remarked:

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.

Although this passing observation must be read with the later conclusion that no one characteristic was decisive, lower courts seized on the suggestion that the relationship between stock investment and debt structure was highly relevant.

Almost immediately, the debt-equity ratio became the outstanding criterion for determining whether stock or indebtedness had been created by a corporation.

Nature of the Ratio.

Under the ratio test, comparison is made between the face amount of outstanding indebtedness of the corporation and the investment in its equity.

Stockholder-held debt is the primary concern of the courts. Inconsistently, however, courts sometimes consider and sometimes disregard debt held by outsiders, the latter being more usual.

On the equity side, an examination is made of the net worth of the company. Par or book value is of no importance; instead, fair market value of the net assets controls. In making his valuation, courts will take into account earned and other types of surplus, unrealized appreciation, good will as well as other intangibles.

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32 326 U.S. at 530.
33 Id. at 526.
34 E.g., Isidor Dobkin, 15 TC 31 (1950), aff'd per curiam, 192 F. 2d 392 (2d Cir. 1951); Lockwood Realty Corp., 17 TCM 247 (1958), on appeal to 6th Circuit.
35 Cf. J. A. Maurer, Inc., 30 TC No. 135 n.2 (Sept. 26, 1958), acq.: "We consider that those funds nominally advanced . . . by banks, but only on the credit and collateral of Reynolds, were in reality advanced by Reynolds who ultimately acquired the notes evidencing these advances."
36 E.g., Miller's Estate v. Com'r, 239 F. 2d 729, 733 (9th Cir. 1956); Kraft Foods Co. v. Com'r, 282 F. 2d 118, 127 (2d Cir. 1956); Ainslie Perrault, 25 TC 439, 450-51 (1955), acq., aff'd per curiam, 244 F. 2d 408 (10th Cir. 1957), cert. den., 355 U.S. 830 (1957); Sheldon Tauber, 24 TC 179, 183-4 (1955), aff'd, 236 F. 2d 159 (6th Cir. 1955), cert. den., 352 U.S. 1031 (1955).
If the equity is too "thin"—that is, if there is a high ratio of debt to the investment allocable to capital stock—courts have tended to conclude that all stockholder-held debt must be treated as part of the equity investment. Only a few isolated cases have recognized the validity of part of the debt. Most of the cases use an all-or-none rule.

**Straightforward debt securities.**

It appears that taxpayer has graduated from the hybrid age, recognizing the obvious pitfalls of an ambiguous instrument. The more recent "thin incorporation" cases involve straightforward debt securities: absolute promise to pay, fixed maturity date, fixed interest, no voting rights, no specified subordination clause. Yet, as the taxpayer developed a more sophisticated approach to the problem, so, too, did the courts evolve more subtle solutions.

**INCONSISTENT RATIO PATTERNS**

In the wake of *John Kelley Co.*, the Tax Court placed greater and greater reliance on the objective debt-equity ratio. This clear standard was certainly easier to apply than an indefinite test based primarily on intent. However, inconsistent ratio patterns soon emerged.

"Equity" Where High Ratio.

With nominal investments in capital stock, the heavy "debt" structures in the following corporations were held really to constitute "equity":

- 1,250:1 ($250,000:$200)—*Swoby Corporation*;
- 1,000:1 ($75,000:$75)—*Kipsborough Realty Corp.*;
- 435:1 ($130,690:$300)—*Joseph V. Reed*;
- 230:1 ($140,000:$610)—*Ryan Contracting Corp.*;
- 180:1 ($90,000:$500)—*Ben P. Gale*;
- 120:1 ($75,000:$621)—*Murphy Planing Mill, Inc.*;
- 97:1 ($97,639:$1,000)—*Two-L Realty Co., Inc.*;
- 57:1 ($57,800:$1,000)—*Colony, Inc.*;

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37 Mill Ridge Coal Co. v. Patterson, 58-1 USTC §9489 (N.D. Ala. 1958); George J. Schaefer, 24 TC 638 (1955); J. Terry Huffstutler, 12 TCM 1422 (1953).
39 9 TC 887 (1947).
40 10 TCM 932 (1951).
41 14 TCM 455 (1955), *aff'd per curiam*, 242 F. 2d 334 (2d Cir. 1957).
42 15 TCM 999 (1956).
43 15 TCM 518 (1956).
44 16 TCM 151 (1957).
45 14 TCM 1147 (1955).
Most of these corporations had issued straightforward debt securities, although several marketed hybrid instruments. Some of the decisions leaned heavily on the debt-equity ratio, while others considered it only as part of the over-all effort of ascertaining the intention of the parties. As noted above, most involved capital stock investments of $1,000 or less, only Isidor Dobkin reaching as high as $2,000.

In cases with capital stock investments over $2,000, the Tax Court still ruled against taxpayers, impressed in part by the debt-equity ratio:

- 10:1 ($100,000:$10,000)—Texoma Supply Co.;
- 9:1 ($76,000:$8,000)—Northline Realty Corp.;
- 8:1 ($100,000:$11,371)—Artistic Venetian Blind Corp.;
- 8:1 ($24,330:$2,940)—Shaker-Lee Theatre Co.;
- 5:1 ($14,582:$3,000)—I. Terry Huffstutler.

Again, most of the instruments were clean-cut, with hybrid features. The decisions generally leaned on all surrounding facts, with varying degrees of reliance upon debt-equity ratio. With the exception of R. M. Gunn, the equity investment in most instances was well

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47 9 TCM 927 (1950), aff'd, 194 F. 2d 540 (6th Cir. 1952).
48 15 TC 31 (1950), aff'd per curiam, 192 F. 2d 392 (2d Cir. 1951).
49 15 TCM 1101 (1956).
50 18 TC 479 (1952), aff'd per curiam, 205 F. 2d 151 (2d Cir. 1953).
51 16 TCM 668 (1957).
52 17 TCM 143 (1958).
53 15 TCM 901 (1956), aff'd per curiam, 242 F. 2d 759 (2d Cir. 1957), cert. den., 354 U.S. 938 (1956).
54 9 TC 350 (1947), aff'd, 167 F. 2d 1001 (3d Cir. 1948).
55 23 TC 789 (1955), acq.
56 25 TC 424 (1955), aff'd per curiam, 244 F. 2d 408 (10th Cir. 1957), cert. den., 355 U.S. 830 (1957).
57 17 TCM 147 (1958).
58 17 TCM 98 (1958).
59 15 TCM 192 (1956), taxpayer’s appeal dismissed (2d Cir. 1957).
60 14 TCM 452 (1955).
61 16 TCM 781 (1951), aff'd, 194 F. 2d 659 (2d Cir. 1952).
62 12 TCM 1422 (1953).
below $12,000. *Gunn* nominally involved $50,000 in capital stock. But this was merely the amount of stock subscribed: only $1,000 was actually paid-in; the balance was unpaid subscriptions.

In *Huffstutler*, the court took a middle-of-the-road position. A 5:1 ratio was computed by taking into account $4,352 borrowed from outside sources. Then, Judge Black held the first $5,500 of stockholder-loans to be capital contributions, but recognized that later advances of $4,730 were intended as loans.

In some extreme cases, the Tax Court has found "equity" where all the consideration was allocated to so-called debt, and none to stock. Illustration of this is found in the following:

- $250,000 : 0 — Robert L. Osborne \(^{63}\)
- $12,685 : 0 — Max Greenhouse \(^{64}\)

Comparable are situations where the consideration received by the corporation was not sufficient to cover the face amount of outstanding debt securities—such as in *1432 Broadway Corporation* \(^{65}\) and in *Hoquet Real Estate Corp.* \(^{66}\). Similarly, equity has been deemed intended when the consideration, though valued higher than the face amount of outstanding indebtedness, was not properly allocated between stock and debt. As to this, see *Sam Schnitzer* \(^{67}\).

**"Debt" Despite Ratio.**

The above rulings, adverse to taxpayers, involved ratios running from 5:1 in *Huffstutler* to 1,250:1 in *Swoby*—not to mention *Osborne* and *Greenhouse* involving no capital at all. In contrast, a series of cases upheld stockholder-debt in the face of ratios running from over 4:1 to almost 40:1.

- 39:1 ($39,268 : $1,000) — Charles H. Scott \(^{68}\)
- 19:1 ($108,418 : $5,533) — Arthur V. McDermott \(^{69}\)
- 7:1 ($35,000 : $5,000) — J. B. Reilly \(^{70}\)
- 6:1 ($3,000,000 : $500,000) — Toledo Blade Co. \(^{71}\)
- 5:1 ($290,000 : $55,000) — Alma de B. Spreckels \(^{72}\)
- 4:1 ($131,000 : $30,000) — Bakhaus and Burke, Inc. \(^{73}\)

At first glance, these cases seem somewhat in conflict with holdings which leaned heavily on the ratio test. Here the court played down

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\(^{63}\) 13 TCM 428 (1954).
^{64} 13 TCM 849 (1954).
^{65} 4 TC 1158 (1945), aff'd, 160 F. 2d 885 (2d Cir. 1947).
^{66} 30 TC No. 55 (June 12, 1958).
^{67} 13 TC 43 (1949), acq., aff'd per curiam, 183 F. 2d 70 (9th Cir. 1950), cert. den., 340 U.S. 911 (1951).
^{68} 14 TCM 1029 (1955), Commissioner's appeal dismissed, (3d Cir. 1956).
^{69} 13 TC 468 (1949), acq.
^{70} 14 TC 22 (1955).
^{72} 8 TCM 1113 (1949).
^{73} 14 TCM 919 (1955), taxpayer's appeal dismissed, (8th Cir. 1957).
debt-equity and returned to emphasizing "intent" as the controlling factor. Greater reliance was placed upon the "surrounding circumstances." In Scott, the sharp disproportion between stockholdings and loans was quite significant, although the court made no mention of it. In McDermott, the slight disproportion between the heavy loans and modest equity hardly merited comment, yet the court felt it noteworthy. Even the absence of formal notes did not prevent the court in Bakhaus and Burke from recognizing the "objective intent" of the parties.

4:1 Ratio Myth.

Notwithstanding this unsettled state of law, a belief developed after John Kelley Co. that a 4:1 debt-equity ratio would clearly be safe.74 This prediction was bottomed on a literal reading of the Supreme Court dictum in the Kelley case. There, Mr. Justice Reed regarded the $400,000 : $100,000 ratio in the companion case, Talbot Mills, as not an "extreme situation." And this view was furthered by holdings in a number of Tax Court cases:

4:1 ($ 100,000 : $ 25,000)—John W. Walter, Inc.;75
3.5:1 ($2,100,000 : $ 60,000)—Ruspyn Corp.;76
3.4:1 ($ 300,000 : $ 86,000)—Chas. Schaefer & Son, Inc.;77
2.5:1 ($ 660,000 : $250,000)—Gazette Telegraph Co.;78
2.3:1 ($ 210,000 : $ 90,000)—Cleveland Adolph Mayer Realty Corp.;79
2.2:1 ($ 605,000 : $270,000)—Warren H. Brown.80

The acquiescences in practically all of these decisions went a long way towards confirming the 4:1 margin of safety. Even Revenue Ruling 56-30381 could be urged as permitting the deliberate use of debt for tax minimization, so long as the ratio was within reasonable limits. Support for this conclusion could be found also in the rejection of the "business purpose" rule in Cleveland Adolph Mayer, and approved by the Tax Court of tax minimization plans in Ainslie Perrault82 and Warren H. Brown.

But all was to come to naught with the Gooding case.83 4:1 proved to be a mirage—as did 1:1!

75 23 TC 550 (1954), acq. See Leonard J. Erickson, 15 TCM 1338, 1343 (1956) (a 4:1 ratio "cannot be said to be so extreme or unrealistic as to provide a strong inference that no part of the indebtedness in question was bona fide.")
76 18 TC 769 (1952), acq.
77 9 TCM 1035 (1950).
78 19 TC 692 (1953), acq., aff'd on other issues, 209 F. 2d 927 (10th Cir. 1954).
79 6 TC 730 (1946), acq.
80 27 TC 27 (1956), acq.
82 25 TC 439 (1955), acq., aff'd per curiam, 244 F. 2d 408 (10th Cir. 1957), cert. den., 355 U.S. 830 (1957).
Decline and Fall of Ratios (1956-1959)

Gooding in the Tax Court.

In Gooding Amusement Co., a family partnership (4/7 father, 2/7 mother and 1/7 minor daughter) incorporated its going business. Net assets valued at approximately $281,000 were transferred to the corporation in exchange for its notes aggregating $232,000 and no par value stock with a stated value of $49,000. Stock and notes were issued directly to the members of the family in proportion to their partnership percentage interests. No identification was made of the portion of assets contributed for shares or the portion contributed for notes.

On its face, Gooding seems to involve a 4.7:1 ratio. But this does not reflect the transfer of the partnership's goodwill. And, under prior authorities, intangible assets must be valued to properly determine the debt-equity ratio. Consequently, "if a reasonable value is attributed to goodwill, the portion of the assets subject to the prior claim of the alleged debt was no greater than that remaining for the stock." In brief, Gooding is a 1:1 ratio case.

"Intent" as the Crucial Issue.

In a comprehensive opinion, reviewed by the full court, Judge Van Fossan emphasized intent as the controlling factor in determining whether a valid debtor-creditor relationship had been created. Courts, he noted, "have been careful not to lay down any all-embracing rule of general application." Rather, "they have invoked and relied upon certain criteria, none of which is, by itself, determinative of the ultimate fact question." Thin capitalization is one of these criteria, but certainly is not decisive of the issue. Thus, though the debt-equity ratio be reasonable, the court is still free to look at the "peculiar facts" of the case to determine the "real intention of the parties."

In treating intent as the crucial issue, Gooding is similar to the pre-1946 decisions. One factor, however, distinguishes it from most of the earlier cases: the notes in question present no problem of interpretation. On their faces, they are unconditional promises to pay a sum certain at a fixed maturity date, with interest thereon not left to anyone's discretion. In form, the instruments are "pure evidences of indebtedness."

Despite this, the court did not regard itself bound by the plain terms of the instruments. Instead, it looked at all the surrounding circumstances to determine whether the real intention of the parties was consistent with the purport of the documents. Justification for this was

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84 Ibid.
85 23 TC 408, 419 (1954).
86 For some unknown reason, Judge Withey has referred to Gooding as a 6.5:1 case. See Warren H. Brown, 27 TC 27, 34 (1956), acq.
87 23 TC at 418.
88 Ibid. at 419.
89 Ibid. at 418.
found in he rules inherent in *Higgins v. Smith*[^90] *Gregory v. Helvering*[^91] and *1432 Broadway Corporation*[^92] the “concept that substance shall prevail over form,” and that “tax avoidance shall not be permitted if the transaction or relationship on which such avoidance depends is a ‘sham’ or lacks genuineness.”[^93]

In holding that debt was not intended, Judge Van Fossan emphasized the following factors:

1. Close family relationship.
2. Amenability of wife and daughter to father’s desires.
3. Partial payment almost entirely to father alone.
4. Insufficient cash balances.
5. Heavy indebtedness to outsiders.
6. Default in payment of most stockholder-notes.
7. No significant nontax consideration for creating debt.

From all this, the court concluded that there had been practical subordination of the stockholder-debt, and that the stockholders did not intend to enforce payment of their notes or assert the rights of bona fide creditors.

*Gooding* may be considered a deviation from the then trend of Tax Court cases because of its modest debt-equity ratio. Under its rationale, extreme ratios may be harmful to the taxpayer but reasonable ratios may not be of much help. Of great moment to the court was “the stark fact that the only substantial purpose motivating the transaction was one of tax avoidance.” And, in the name of “substance” and “genuineness,” Judge Van Fossan was not willing to approve the plan.

The result on appeal was not wholly unexpected.

*Gooding in Sixth Circuit.*

The Sixth Circuit affirmed *Gooding* by a two to one vote. But the majority opinion says little more than that the decisive factor—“the real intention of the parties”—is a factual issue to be determined by the trial court, and that intention may be established by evidence aliunde.[^94]

Writing for the majority, Judge Martin stated that no rule of thumb may be derived from prior authorities, and that each case must be judged upon its own facts. He merely paraphrased the Tax Court’s findings and conclusions in detail, listed appellate cases favorable to the Commissioner and cases favorable to the taxpayer, and concluded that “the findings of fact of the tax court are supported by substantial

[^90]: 308 U.S. 473 (1940).
[^92]: 4 TC 1158 (1945), aff'd, 160 F. 2d 885 (2d Cir. 1947). See note 25.
[^93]: 23 TC at 418.
[^94]: Gooding Amusement Co. v. Com'r, 236 F. 2d 159, 166 (6th Cir. 1956), *cert. den.*, 352 U.S. 1031 (1957).
evidence and are not clearly erroneous, and that its conclusions were appropriately drawn.98

In contrast, Judge McAllister noted in his dissent99 that straightforward debt instruments were involved; they were treated as such in the corporate records and were so held out to creditors; that "there was never any subordination, in a legal sense"; and both the stockholders and corporation recognized the notes as "real and bona fide indebtedness." He believed that the Tax Court's findings were without any support and that there was no evidence "from which reasonable inferences could be drawn that the parties did not intend that the notes should create a bona fide indebtedness."

A review of the decisions referred to by the majority suggests that Judge McAllister more accurately evaluated previous appellate court authorities. Except for Matthiessen v. Commissioner,72 every debt-equity case cited by Judge Martin favorable to the Commissioner involved a hybrid security. It was only in the context of ambiguous instruments that these appellate decisions had found alleged debt to be really intended as equity. In Matthiessen, involving a ratio of over 6:1, the Second Circuit invalidated a simple debt instrument; but, as we shall see below, this eminent court is currently having extreme difficulty in agreeing upon a satisfactory ratio decidendi for disposing of debt-equity cases.

The Sixth Circuit decision in Gooding may be regarded as a limited victory for the Commissioner. Two judges gingerly supported a Tax Court finding that straightforward debt was not intended as bona fide indebtedness notwithstanding a reasonable debt-equity ratio. No mention was made of the ratio. In fact, the court stated that no rule of thumb would govern and that the "real intention" of the parties would have to be determined from all surrounding circumstances.

Other circuits are even more hesitant in following the Tax Court's approach to stockholder-held debt. And, in some, the judges are quite clear they will not be swayed by debt-equity ratio alone.

**Fifth Circuit Rejects Ratio Test.**

No court has been more definite in rejecting the ratio test than the Fifth Circuit. Rowan v. United States98 was the occasion. At issue was the treatment of $125,000 in open accounts in favor of husband and wife who had invested only $9,000 in capital stock. The debt-equity ratio was therefore almost 14:1, with no formal evidence of indebtedness issued. In this setting, the Government contended that open account advances made over a period of years were to be treated

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95 236 F. 2d at 166.
96 id. at 166-167.
97 19 F. 2d 659 (2d Cir. 1952).
98 219 F. 2d 51 (5th Cir. 1955).
as capital investment, giving rise to long term capital losses. The Court of Appeals, however, agreed with the taxpayer that a valid debt had been created.

At the outset, Judge Tuttle gave recognition to the tax doctrine that the Commissioner is not bound by terminology used by taxpayers "if such terminology is actually used to disguise something quite different." Gregory v. Helvering was cited for this sham exception. However, he quickly added that he had seen no authority that stockholders could not determine how much of their funds they might risk as capital and how much as credit. Elaborating, he said:99

If they make such a determination and it is clear that such is their intent, the fact that . . . this leaves them in a position to enjoy more favorable deduction privileges than if they had put it all in as capital . . . does not entitle the Commissioner of Internal Revenue to rewrite their balance sheet for them and show to be capital what was intended to be a loan.

The touchstone in these cases is the "true intent" of the parties, to be ascertained from all relevant facts and circumstances. Debt-equity ratio, however, is not a relevant factor. For Judge Tuttle believes it "would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation."100

While "it is entirely within the competence of Congress to provide by statute for such a ratio if it deems it advisable or necessary," the Fifth Circuit did not believe it to be within its province to do so. Nor did it believe it would "further the desirable end of certainty in taxes" for the court to determine a ratio.

Following this clear-cut statement, the court explained that it had been referring only to situations where there was no evidence of intent to make a contribution to capital other than the debt-equity ratio. Acknowledgment was made that there might be cases involving facts from which other inferences could be drawn. For example, initial payments of both capital and advances might be made for acquisition of capital assets—although the court noted that this was not conclusive. Stock certificates might be issued. Or there might be subordination; or "inordinately postponed" due dates; or agreement not to enforce collection; or provision for interest payments only out of earnings; or advancements as the initial fund to commence corporate life; or a combination of the foregoing.

That this final dictum in Rowan did not weaken its position on ratio, is evident from the Fifth Circuit's later opinion in Sun Proper--

99 Id. at 54. (Italics added.)
100 Id. at 55.
ties v. United States. There, the ratio was 310:1. A sole stockholder had invested only $400 in stock, and almost immediately thereafter allegedly sold a warehouse building to the corporation for approximately $125,000. No note was issued; nor were there provisions for interest or security. Nevertheless, the corporation sought to treat this as a "sale," seeking a stepped-up basis and greater depreciation deduction.

In upholding the taxpayer, Judge Tuttle again rejected the "thin incorporation" argument. Rowan was referred to as authority for the court's position. The absence of interest provisions was also deemed inconclusive. Of greater significance in the eyes of the court were the fixed payments required, the language of the document, and the book entries.

In the Fifth Circuit, therefore, debt-equity ratio is of no importance. Instead, we find this court espousing the approach so common to the Tax Court and appellate courts in the pre-1946 period.

In passing, mention should be made that the Sun Properties decision also rejected "business purpose" as a guide in determining the genuineness of the purported sale. As will be noted later, however, other courts are giving greater emphasis to nontax motivations in testing the bona fides of stockholder-held debt.

Seventh Circuit Compares with Fifth.

The Seventh Circuit indicates support of the Fifth Circuit approach to thin incorporation, although it has not so clearly denounced the value of the ratio test. In Sarkes Tarzian, Inc. v. United States, it leaned heavily on Rowan but felt that the facts before it more closely fitted the exceptional type cases mentioned in the Rowan dictum.

The facts in Sarkes Tarzian are quite detailed; but it appears that the amount allocated to stock was $31,860 while at least $1,181,808 was said to be debt—a ratio of over 37:1. The transaction took the form of a sale of assets, much like Sun Properties; the issue presented was depreciation of an alleged stepped-up basis.

Summary judgment for the plaintiff was reversed as the appellate court believed that conflicting possible inferences might be drawn from the evidence. Judge Swaim, speaking for a unanimous court, felt the form of the transaction might be disregarded because of subordination of note and purchase price balance postponement of due dates, payments discontinued and collections not enforced, no dividend payments and thin incorporation. In reaching this result he quoted generously from Rowan v. United States. At the same time, he plainly

\(^{101}\) 220 F. 2d 171 (5th Cir. 1955).
\(^{102}\) Id. at 174-75.
\(^{103}\) 240 F. 2d 467 (7th Cir. 1957).
pointed out that the ultimate conclusion depends "on the intent of the parties and this intent is to be ascertained from all relevant facts and circumstances, and of necessity the case is largely dependent upon circumstantial evidence."\textsuperscript{104}

A much-cited earlier opinion of the Seventh Circuit, \textit{Com'r v. Meridian & Thirteenth Realty Co.},\textsuperscript{105} offers contrast in the judicial thinking of this court. There, a hybrid preferred stock was examined in detail to see whether an "interest" deduction should be allowed. The Board of Tax Appeals had answered in the affirmative in favor of the taxpayer; and the appellate court reversed. But, in making its determination, the court stated the problem to be simply "the construction of documents to ascertain the real intention of the parties."\textsuperscript{106}

\textit{Meridian} was a 1942 decision decided by three judges different from those sitting in \textit{Sarkes Tarzian}. Its complete concern with the four corners of the controlling instruments is typical of the pre-\textit{Kelley} decisions, both in the Tax Court and Courts of Appeals. \textit{Sarkes Tarzian} does not overrule \textit{Meridian}, but it certainly indicates a much broader approach in searching for "intent": the instrument alone will not decide the issue; rather, all relevant facts will be taken into account, including thin incorporation.

It is of interest that, on remand of \textit{Sarkes Tarzian}, District Judge Holder again decided in favor of the taxpayer finding a valid sale of assets, not a capital contribution. In reaching this result, he separated and analyzed the initial exchange of part of the assets for capital stock, ruling that the corporation was then "adequately capitalized . . . in that the true ratio of the value of its equity capital to its debts was at least two to one."\textsuperscript{107}

\textit{Ninth Circuit Denounces "Dictation" of Ratio.}

The Ninth Circuit gives great weight to the intentions of the parties. Thus, in the leading case of \textit{Wilshire & Western Sandwiches, Inc. v. Com'r}\textsuperscript{108} it had little difficulty in allowing interest deductions on notes held by stockholders in proportion to their capital stock investments. $55,000 had been invested by four incorporators to finance the construction of a restaurant. After construction was completed, the investment was allocated $30,000 to capital and $25,000 to debt. Initial book entries did not treat the advances as loans; interest payments were delayed; and payments of interest and principal were ultimately made from profits, as the incorporators expected.

Reversing the Tax Court, Judge Orr took the position that the "intent of the parties as to the nature of the transaction controls."

\textsuperscript{104} \textit{Id.} at 470.
\textsuperscript{105} 132 F. 2d 182 (7th Cir. 1942). See note 18.
\textsuperscript{106} \textit{Id.} at 184.
\textsuperscript{107} 159 F. Supp. 253, 260 (S.D. Ind. 1958).
\textsuperscript{108} 175 F. 2d 718 (9th Cir. 1949).
While proportionate lending by stockholders subjects the transaction to close scrutiny, under his view it does not, "as a matter of law, require the transaction to be treated as a stock investment, regardless of intent." The court felt the transaction contained "all the elements of a debtor-creditor relationship": viz., meeting of the minds as to intent of the nature of the advance; transfer of consideration; and promise to pay evidenced by negotiable promissory notes, with an unconditional and legally enforceable obligation for the payment of money.109

In *Schnitzer v. Com'r,*110 the Ninth Circuit affirmed per curiam a Tax Court opinion treating alleged debt as a contribution to capital. That was a case where the "true intent" of the parties had been found more consistent with the creation of equity: the parties knew the initial advances were "only a fraction" of their minimum requirements; moneys were advanced on open account, without allocation to stock or debt, and without even issuance of stock for a number of months. Taxpayers presented a murky record of their intentions, and there was hardly room for comment on the Tax Court's findings against them. A similar result was reached in *Root v. Com'r*111 when the intentions of the parties were clouded by the absence of both notes and provisions for interest; although in *Maloney v. Spencer,*112 this same court found indebtedness intended in open account advances by a sole stockholder.

In *Earle v. W. J. Jones & Son, Inc.*,113 the Ninth Circuit had the occasion to consider substantial corporate debt held by an 80% stockholder. The total stockholder loans amounted to $317,106 against a stated paid-in capital of $1,000; but, by valuing the assets transferred for stock at more than $50,000, the court found the ratio to be 6:1. Upholding the taxpayer, the court felt it could distinguish previous cases which had used thin incorporation to test the "substance" of the transaction. The validity of the debt was said to depend upon the "determinative intent" of the parties,114 and evidence of business purpose and book treatment were preferred over mere inferences to be drawn from a comparison of debt to equity.

More recently, the Ninth Circuit clarified its views on debt-equity in *Miller's Estate v. Com'r.*116 The Tax Court had held that there had

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109 Id. at 720-21.
110 183 F. 2d 70 (9th Cir. 1950), aff'd per curiam 13 TC 43 (1949), cert. den., 340 U.S. 911 (1951). Cf. Brinker v. United States, 221 F. 2d 478 (9th Cir. 1955), aff'd per curiam (116 F. Supp. 294 (N.D. Cal. 1953) ("objective intent of the parties").
111 220 F. 2d 240 (9th Cir. 1955).
112 172 F. 2d 638 (9th Cir. 1949).
113 200 F. 2d 846 (9th Cir. 1952).
114 Id. at 847.
115 239 F. 2d 729 (9th Cir. 1956).
been no bona fide intention to create debt when three partners had incorporated their business with $1,050 of stated capital, "an absurdly low capitalization," and thereafter were issued corporate notes aggregating $174,571. In reversing, the appellate court first noted that, taking good will into account, the capital stock was worth approximately $100,000. Judge Pope then remarked that the relation of debt to this equity was not disproportionate and that "no such ratio has ever been held to create a fatally thin capitalization." To this, he added that the court knew of "no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt . . . and . . . it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as 'normal,' and hence subject to approval by the Commissioner."117

The Ninth Circuit believed that the parties intended to create a genuine indebtedness "since the written instruments objectively manifest their intent to do just that." In reply to the Commissioner's argument that transactions may be disregarded if they are a "sham" or "masquerade," the court found significant nontax motivations in the personal and family benefits to be derived by the individual partners.

Argument that the parties were relying upon expected earnings for repayment of the debts did not impress the court. This, it thought, was true of many borrowers. Gooding Amusement Co.118 was distinguished on the grounds that actual defaults in payment of notes there "could conceivably give rise to the inference that they were not intended to be paid."

All in all, the Ninth Circuit indicates respect for stockholder-held debt when evidenced by an instrument calling for an absolute promise to pay a sum certain at a reasonably near future date. It recognizes, beyond this, that consideration must be given to the sham phase of Gregory v. Helvering.119 Yet the court seems to find that test satisfied in a showing of nontax purposes personal to the individual investors.

Second Circuit Dilemma.

Any sense of orderliness on debt-equity in the Courts of Appeals is disputed by decisions in the Second Circuit.

Before the Supreme Court's decision in John Kelley Co., the Second Circuit had begun to disregard stockholder-held debt when it was substantial in relation to the equity investment. Janeway v. Com'r120

116 24 TC 923, 934 (1955), rev'd 239 F. 2d 729 (9th Cir. 1956).
117 239 F. 2d at 734. (Italics added.)
118 236 F. 2d 159 (6th Cir. 1956). See note 83.
120 147 F. 2d 602 (2d Cir. 1945). See note 23.
and Cohen v. Com'r\textsuperscript{121} were early cases decided against taxpayers. But, even at that time, the court was not consistent. For it had previously upheld extreme debt structures in Com'r v. O.P.P. Holding Corp.\textsuperscript{122} and in Estate Planning Corp v. Com'r.\textsuperscript{123}

Subsequent to John Kelley, a long line of cases against taxpayers bear the imprint of the Second Circuit: 1432 Broadway Corporation v. Com'r,\textsuperscript{124} Dobkin v. Com'r,\textsuperscript{125} Matthiessen v. Com'r,\textsuperscript{126} Bair v. Com'r,\textsuperscript{127} Bachrach v. Com'r,\textsuperscript{128} Reed v. Com'r,\textsuperscript{129} Gregg Co. of Delaware v. Com'r,\textsuperscript{130} and 241 Corporation v. Com'r.\textsuperscript{131} Most of these involved unambiguous debt instruments, with either nominal capital investments or heavy debt structures. The court seemed to have accepted the Tax Court's sweeping denunciation of stockholder-held debt when tax avoidance was the primary motivation for the debt-equity structure. This, at least, could be concluded until Kraft Foods Co. v. Com'r.\textsuperscript{132}

Kraft Foods Co. v. Com'r.

Kraft Foods Co., a wholly-owned subsidiary of National Dairy, with a stated capital of $2,000,000, declared a dividend of $30,000,000 in 6% debentures maturing in 14 years. It did this following the 1934 abolition of the privilege of filing consolidated income tax returns. Primary motivation for this was tax minimization: to shift to its parent each year $1,800,000 of its earnings, without any tax cost. The debentures were simple in form, containing an unconditional promise to pay on a fixed maturity date, with the usual provisions for acceleration on default. In 1941, the interest rate was reduced from 6% to 4%; and in 1948, the due date, payment was not made on principal but the debentures were replaced by a new 4% issue, still outstanding at the time of the controversy.

The Commissioner sought to deny the Kraft debentures, urging: (1) parent-subsidiary relationship, (2) no new money contributed, (3) no business purpose, only a tax-saving purpose, (4) debt-equity ratio was disproportionate, (5) no genuine intention to create a debt. These arguments were adopted in essence by the Tax Court, which did not believe a debtor-creditor relationship was ever intended. It concluded that Kraft was "for practical purposes" a department of

\textsuperscript{121} 148 F. 2d 336 (2d Cir. 1945). See note 24.
\textsuperscript{122} 76 F. 2d 11 (2d Cir. 1935).
\textsuperscript{123} 101 F. 2d 15 (2d Cir. 1939).
\textsuperscript{124} 160 F. 2d 885 (2d Cir. 1947), aff'd per curiam 4 TC 1158 (1945).
\textsuperscript{125} 192 F. 2d 392 (2d Cir. 1951), aff'd per curiam 15 TC 31 (1950).
\textsuperscript{126} 194 F. 2d 659 (2d Cir. 1952).
\textsuperscript{127} 199 F. 2d 589 (2d Cir. 1952) ("fly-by-night corporation").
\textsuperscript{128} 205 F. 2d 151 (2d Cir. 1953), aff'd per curiam 18 TC 479 (1952).
\textsuperscript{129} 242 F. 2d 334 (2d Cir. 1957), aff'd per curiam 14 TCM 455 (1955).
\textsuperscript{130} 239 F. 2d 498 (2d Cir. 1956).
\textsuperscript{131} 242 F. 2d 759 (2d Cir. 1957), aff'd per curiam 15 TCM 901 (1956), cert. den., 354 U.S. 938 (1957).
\textsuperscript{132} 232 F. 2d 118 (2d Cir. 1956), rev'd 21 TC 513 (1954).
National Dairy which did not "in a real sense" become a creditor of its wholly-owned subsidiary. Emphasized by Judge Turner was the *Higgins v. Smith* approach—that the Government may look at actualities and disregard the form employed if it is "unreal or a sham."

The Second Circuit reversed in a 2 to 1 opinion—Waterman and Medina for the majority, Chief Judge Clark dissenting. Allowing the interest deduction, the majority opinion is clear in setting forth the issue: (1) the debentures contained all the necessary features of debt and none ordinarily associated with equity, clearly evidencing the taxpayer's intention to create valid indebtedness; (2) the problem therefore was not one of ascertaining intent as this had been objectively manifested; (3) instead, the problem was "whether the intent and acts of these parties should be disregarded in characterizing the transaction for federal tax purposes." The appellate court reviewed all of the factors considered below but found none decisive. No "paramount policy of federal tax law" was found to justify disregarding the plain purport of the debt instruments.

Under the majority opinion two going corporate ventures are free to minimize their taxes by unequivocal acts indicating their intention to create indebtedness, with no special business purpose required. Judge Waterman is not concerned that in a "broad economic sense, of course, it is of limited significance what form a sole stockholder's investment in a wholly-owned corporation takes." Nor is he impressed by argument that the parent would be subordinated to claims of outside creditors in bankruptcy. As to the relation of debt to equity in *Kraft*, he found the "real values" established a ratio of 10:13—$30,000,000 debt and $39,000,000 equity. The debt-equity ratio, he noted, "is of great importance in determining whether an ambiguous instrument is a debt or an equity interest; and perhaps this consideration is of such overriding importance that even an indebtedness valid under state law should be disregarded for federal tax purposes." But 10:13 was not considered a disproportionate ratio.

Chief Judge Clark's dissent is terse and entirely consistent with his previously expressed views in the tax field. In place of the literal approach of Judge Waterman, he prefers the Tax Court's use of objective standards for testing intercorporate indebtedness. He undoubtedly draws adverse inferences from the parent-subsidiary relationship and absence of business purpose for issuing debt securities. In fact, he could find hardly anything to offset the objective indicia of lack of indebtedness in the ordinary sense—"a debt whose nonpayment leads to

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338 308 U.S. 473 (1940), cited in 21 TC at 597.
339 232 F. 2d at 123.
340 232 F. 2d at 124.
341 Id. at 127.
foreclosure or attachment and execution”—except the subjective desire to secure maximum tax relief. Under his view, close corporation indebtedness held proportionately by stockholders would almost invariably be nullified. This is substantially the approach of the Tax Court in Gooding as well as in Kraft.

Notwithstanding this dissent, stockholder-held debt seemed to have received a blessing in Kraft—at least from two judges in the important Second Circuit. But this was no longer so clear after the three opinions written in Gilbert v. Com'r.

**Gilbert v. Com'r.**

In Gilbert, Messrs. Gilbert and Borden invested $40,000 each in the capital stock of their corporation, and agreed that, if additional funds were required, financing “would be generally on about a 50-50 basis.” Over a period of three years, they then provided approximately $175,000, most advanced against the corporation’s 37% demand notes. The corporation dissolved and Gilbert claimed a bad debt deduction. However, the Tax Court disallowed the deduction on the grounds that “the advances by Benjamin [Gilbert] were, in reality, contributions of risk capital and did not give rise to bona fide debts on the part of the corporation.”

The Second Circuit was unanimous in its dissatisfaction with Judge Kern’s opinion—although Judge Medina wrote a “majority” opinion expressing his own view, Judge Waterman a concurring opinion, and Judge Learned Hand a dissenting opinion. The three judges agreed that the Tax Court had not properly stated the ground on which its decision rested, but they could not get together in phrasing the principles to govern the Tax Court in its reconsideration of the case. In dissenting, Judge Hand apparently was prepared to affirm the lower court opinion despite his disagreement with its form.

All three judges seem to have agreed that the parties “truly intended” to create debt. But they were faced with the difficult issue that, if this were so, what were the circumstances, if any, under which this debt could be disregarded for tax purposes?

Judge Medina at first seems to toy with the possibility of using “business purpose” as a vehicle for outlawing a plain debt instrument. Finally, however, he explains his careful analysis of Gregory v. Helvering as meaning that literalness is to be avoided in construing tax statutes, and that “statutory terms are not to be interpreted independent of their context and underlying policy.” From this, two questions are posed which he believes must be answered in this type case: (1) “whether the characterization urged by the taxpayer accords with

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138 232 F. 2d at 129.
139 248 F. 2d 399 (2d Cir. 1957), rev'g and remanding 15 TCM 688 (1956).
140 15 TCM at 694.
141 293 U.S. 465 (1935).
substantial economic reality," and (2) "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business.\textsuperscript{142} He regards the latter as the "significant factor" intended by Congress in its use of the terms "indebtedness" and "debt." For he ultimately believes that "it would do violence to the congressional policy to permit an 'interest' deduction where the 'loan' is so risky that it can properly be regarded only as venture capital."\textsuperscript{143}

Judge Waterman, who wrote the majority opinion in \textit{Kraft}, has an even harder time in reconciling \textit{Gilbert} with \textit{Kraft}. At the outset, he makes it clear that his opinion is based on the assumption that the parties "truly intended to create debt." However, he notes that "numerous cases" suggests critical factors in dictating when it would be improper, for tax purposes, to characterize advances as loans. Among them are: continuous advances to meet needs for both capital assets and working capital, without normal creditor safeguards; lack of security, despite default in interest and a history of continuous losses; no attempt to enforce obligations; making advances "under circumstances closely approximating those associated with the investment of equity capital"; agreement among stockholders to maintain proportionality; inadequacy of equity capital contributed.\textsuperscript{144} As to the last, "thin incorporation," he finds it of no value in the \textit{Gilbert} case, for the debt-equity ratio there never exceeded 2.19 to 1. Thus, he believes: "Once it is established that the parties' equity investment is more than nominal, the means by which the corporation's activities are financed is a matter to be handled in whatever way seems most advantageous to it."

But after analyzing past authorities and tests, Judge Waterman hedges his opinion by stating that the only factors tending to support the Tax Court's ruling in \textit{Gilbert} are (1) advances in proportion to equity investment, and (2) continuous advances without regard to normal credit safeguards. And, he hedges even further by concluding that: "Whether these factors are sufficient to preclude characterization of the advances as loans for income tax purposes is a question which, at least in the first instance, must be answered by the Tax Court."

In a brisk dissent, Judge Hand is critical of his brethren, saying that he is not clear what the majority intends to be the form of test to be applied by the Tax Court: To say that it is whether the trans-

\textsuperscript{142} 248 F. 2d at 406.
\textsuperscript{143} Id. at 407. In testing the degree of risk and the expectations of repayment, Judge Medina lists six subsidiary lines of inquiry: debt-equity ratio; agreement to maintain proportionality with equity investment; presence of tax avoidance motives; use to which funds were put; whether outside investors would make such advances; and lack of reasonable expectation of repayment.
\textsuperscript{144} Id. at 409-10.
action has 'substantial economic reality,' or 'is in reality what it appears to be in form,' or is a 'sham' or a 'masquerade,' or 'depends upon the substance of the transaction': all of these appear to me to leave the test undefined, because they do not state the facts that are to be determinative.'

According to Hand, the income tax statute imposes liabilities upon taxpayers based on their financial transactions; and if a taxpayer enters into a transaction without appreciably affecting his beneficial interest other than reducing taxes, the law will disregard it.

**Summary of Second Circuit's Gilbert Opinions.**

After reading the three opinions in Gilbert, the Tax Court on remand appeared somewhat confused. Judge Kern simply stated: "We are in some doubt as to what 'proceedings consistent with this opinion' or what 'further proceedings' are called for under the judgment of the Court of Appeals." Grabbing what he believed to be the proper horn of the dilemma, he then made additional findings in an effort to satisfy at least a majority of the Second Circuit. Judge Kern saw fit to close his opinion with what almost amounts to a prayer: "We have the temerity to hope that we have adequately assigned the reasons for that conclusion, and have thus complied with the judgment of the Court of Appeals."

In the Medina-Waterman-Hand opinions, the judges seem to be stumbling in trying to mount the hurdle of Gregory v. Helvering. Although the doctrine of that case has been said to mean "all things to all men," it is often cited for two distinguishable though related propositions: (1) "the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope," and (2) the way a taxpayer reports a transaction for income tax purposes may be disregarded when "it does not evidence the entire true transaction and is a mere pretense"—a "sham" or a "masquerade." In its first connotation, Gregory has applicability to every tax case, including thin

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145 Id. at 412. Judge Hand would apply the following test: "When the petitioners decided to make their advances in the form of debts, rather than of capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?"

146 Benjamin D. Gilbert, 17 TCM 29 (1958).

*Note*: After the completion of this article, the 2nd Circuit, speaking through three different judges—Hincks, Lumbard and Moore—affirmed the Tax Court's second opinion. Gilbert v. Com'r, 262 F. 2d 512 (2d Cir. 1959). In the last analysis, the court simply concluded "it cannot be said that Benjamin [Gilbert] has sustained the burden of proof which he must bear in showing that the Tax Court's decision is erroneous."

147 293 U.S. 465 (1935).

148 PAUL, STUDIES IN FEDERAL TAXATION 126 (3rd Series 1940).

149 Per Judge Hand dissenting in Gilbert v. Com'r, 248 F. 2d 399, 411 (2d Cir. 1957).

150 Compare Judge Waterman's statement in his concurring opinion. Id. at 408n.2. Also, see Minnesota Tea Co. v. Helvering, 302 U.S. 609, 614 (1938); Griffiths v. Com'r, 308 U.S. 355, 358 (1939); Higgins v. Smith, 308 U.S. 473, 476 (1940); Com'r v. Court Holding Co., 324 U.S. 331, 334 (1945); cf. Bazley v. Com'r, 331 U.S. 737 (1947).
incorporation. But, in its second context, it may not be used to defeat actual transactions by active business concerns simply because of their tax motivation. Thus, in *Kraft Foods Co. v. Com' r*, the use of debt for tax minimization was upheld since "the acts were real" and the parties involved could not be "characterized as sham entities." The general business purpose argument of the Government was rejected in *Kraft*; and the same result seems warranted in *Gilbert*—unless the Second Circuit is prepared to extend that broad doctrine.

**Corporate Personality and Business Purpose.**

Hand, who may be considered the father of *Gregory*¹¹¹, has long taken the position that corporate personality will not be disregarded merely because of the presence of tax avoidance.¹² The separateness of the corporate entity is one of the cornerstones of our present income tax law, and this legal "fiction" is not lightly to be put aside.¹³ So long as the corporation actively functions, it will be given tax recognition. When tax minimization is sought by such a going concern through issuing debt securities, it is mere cant to say that this is "an improper objective of corporate management."¹⁴ Under the present form of the Code, therefore, a *Gregory*-type business purpose attack on clear debt instruments should not be sufficient if the parties establish that they "really and truly" intended to create a debtor-creditor status.¹⁵

While Medina and Waterman were not prepared to go beyond their *Kraft* decision, Hand ingeniously seems to lay down a broader business purpose doctrine¹⁶ for the debt-equity issue: that is, although a business purpose may be assumed for a closely-held corporation through its active functioning, it is still necessary to find special nontax motivation for a shareholder's investment in debt security. In the absence of such a finding, Judge Hand would presumably reject any form of stockholder-held debt. *Kraft Foods*, for example, would

¹¹¹ Helvering v. Gregory, 69 F. 2d 809, 811 (2d Cir. 1934), rev'd 27 BTA 223 (1932): "But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution."

¹² See Com'r v. National Carbide Corp., 167 F. 2d 304 (2d Cir. 1948), aff'd 336 U.S. 422 (1949); cf. National Investors Corp. v. Hoey, 144 F. 2d 466 (2d Cir. 1944). Also, see Paymer v. Com'r, 150 F. 2d 334 (2d Cir. 1945), written by Judge Chase for the unanimous court of Hand, Swan and Chase.

¹³ See Sage v. Com'r, 83 F. 2d 221, 225 (2d Cir. 1936): "... when a statute is drafted upon a concept like that of the reality of corporate personality, I do not see how that concept can fail to be determinative." Also, see Prunier v. Com'r, 248 F. 2d 818, 821 (1st Cir. 1957); cf. Hyland v. Com'r, 175 F. 2d 422, 424 (2d Cir. 1949) (constructive receipt issue).

¹⁴ See Sage v. Com'r, 83 F. 2d 221, 225 (2d Cir. 1936). See note 155.

¹⁵ For a rejection of the distinction between "shareholder purpose" and "corporate purpose," see Lewis v. Com'r, 176 F. 2d 646, 649 (1st Cir. 1949). Also, see Spear, "Corporate Business Purpose" in Reorganization, 7 TAX L. REV. 225 (1948); Michaelson, "Business Purpose" and Tax Free Reorganizations, 61 YALE L. J. 14 (1952).
probably merit his dissent; for, there, the court assumed that “tax considerations were the primary motivation.”

Judge Hand’s Gilbert opinion is in sharp contrast to his earlier opinion in *Loewi v. Ryan*, but it is in tune with recent Tax Court decisions which use tax avoidance as a heavy weapon in debt-equity cases. His test—“did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than tax-wise”—was recently used against the taxpayer in *Arlington Park Jockey Club, Inc. v. Sauber*.* Its terminology bears comparison with some of the language in Miller’s Estate;* although the Ninth Circuit, as noted above, has indicated greater elasticity in dealing with this problem.

**Other Circuits and District Courts.**

Most of the development in thin incorporation has occurred in the Second, Fifth, Sixth, Seventh and Ninth Circuits. Every other circuit has been called upon to consider the issue in one form or another, but has not had occasion to make significant contributions to this field. For the most part, other appellate courts have approached the problem along pre-1946 lines—searching for the real intent of the parties, focusing primarily upon the terms of the instrument and only occasionally upsetting clear debt instruments because of the presence of tax avoidance motivations.*

District Courts have also passed upon the debt-equity issue. Recently a number of them have made careful analyses of the underlying problems, but, as might be expected, there is hardly any firm basis for reconciling these opinions.

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157 229 F. 2d 627, 629 (2d Cir. 1956).
159 239 F. 2d 729 (9th Cir. 1956). See note 115.
160 1st Circuit: Haffenreffer Brewing Co. v. Com’r, 116 F. 2d 465 (1st Cir. 1940), cert. den., 313 U.S. 567 (1941); Com’r v. H. P. Hood & Sons, Inc., 141 F. 2d 467 (1st Cir. 1944); Talbot Mills v. Com’r, 146 F. 2d 809 (1st Cir. 1944), aff’d, 326 U.S. 521.
3d Circuit: John Wanamaker, Philadelphia v. Com’r, 139 F. 2d 644 (3rd Cir. 1943); Mullin Bldg. Corp. v. Com’r, 167 F. 2d 1001 (3d Cir. 1948), aff’d per curiam 9TC 350 (1947); Messenger Publishing Co. v. Com’r, 168 F. 2d 903 (3d Cir. 1948), aff’d per curiam 6 TCM 958 (1947); Pierce Estates, Inc. v. Com’r, 195 F. 2d 475 (3d Cir. 1952).
4th Circuit: Brown-Rogers-Dixson Co. v. Com’r, 122 F. 2d 347 (4th Cir. 1941); Smoot, Sand & Gravel Corp. v. Com’r, 241 F. 2d 197 (4th Cir. 1957), cert. den., 354 U.S. 922 (1957); Lee Telephone Co. v. Com’r, 58-2 USTC §9882 (4th Cir. 1958).
8th Circuit: Wetterau Grocer Co., Inc. v. Com’r, 179 F. 2d 158 (8th Cir. 1945); Crown Iron Works Co. v. Com’r, 245 F. 2d 357 (8th Cir. 1957).
10th Circuit: Bowersock Mills & Power Co. v. Com’r, 172 F. 2d 904 (10th Cir. 1949); Howek v. Hinds, 215 F. 2d 673 (10th Cir. 1954); Estate of Harry M. Liggett v. Com’r, 216 F. 2d 548 (10th Cir. 1954); Crawford Drug Stores v. United States, 220 F. 2d 592 (10th Cir. 1955).
For example, in the following cases, involving high ratios, alleged debt was held properly classified as "equity";

18,800:1 ($564,000:$ 30)—Byerlyte Corp.;\(^{161}\)
109:1 ($109,650:$ 1,000)—Harkins Bowling, Inc.;\(^{165}\)
22:1 ($455,000:$20,000)—Arlington Park Jockey Club, Inc.;\(^{163}\)

Byerlyte involved no notes, no provision for interest, no fixed maturity date;\(^{164}\) Harkins Bowling and Arlington Park, straightforward debt instruments. All were extremely-well considered opinions; all noted the high debt-equity ratio; all found solace in the Second Circuit's opinion in Gilbert. Arlington Park was particularly intrigued by Judge Hand's dissent in that case.

By way of contrast, the following cases, most far less extreme than those above, found "debt" truly intended under the terms of the instruments:

24:1 ($ 24,000:$ 1,000)—Associated Investors, Inc.;\(^{165}\)
14:1 ($ 134,800:$ 9,500)—Hill v. United States;\(^{166}\)
9:1 ($ 111,000:$ 13,200)—Atlantic Acceptance Corp.;\(^{167}\)
4:1 ($1,600,000:$400,000)—Los Angeles Shipbuilding;\(^{168}\)
1. 3:1 ($ 375,000:$291,700)—Dominion Oil;\(^{169}\)
.8:1 ($ 450,000:$550,000)—Dennis Corp.\(^{170}\)

Los Angeles Shipbuilding was concerned with advances made on open account; all others possessed clear debt securities. The "intent of the parties" was the heart of the matter in these cases, with heavy reliance upon Wilshire & Western Sandwiches, Inc.\(^{171}\) and sometimes Rowan.\(^{172}\)

As can be seen, no clear-cut answer is provided in either the Courts of Appeals or District Courts. However, one does find there a measure of judicial self-restraint not always evidenced in the Tax Court.

\(^{165}\) Associated Investors, Inc. v. United States, 57-1 USTC §9396 (D.Kan. 1956).
\(^{167}\) Atlantic Acceptance Corp. v. Tomlinson, 58-2 USTC §9892 (S.D. Fla. Oct. 24, 1958) (court refers to ratio as "about 15 to 1").
\(^{168}\) Los Angeles Shipbuilding & Drydock Corp. v. United States, 58-2 USTC §9893 (S.D. Cal. Oct. 8, 1958) (facts unclear; capital might be over $400,000).
\(^{171}\) 175 F. 2d 718 (9th Cir. 1949). See note 108.
\(^{172}\) 219 F. 2d 51 (5th Cir. 1955). See note 98.
CURRENT CHAOS IN THE TAX COURT.

Buckshot Approach.

The Gilbert case, it will be recalled, was remanded because the original Tax Court Opinion did not state the grounds upon which the decision rested. On remand, Judge Kern—despite his understandable confusion over the Second Circuit’s directions—made the following additional findings to support his conclusion that the advances did not give rise to debts:

1. Stockholders anticipated that capital stock investment “would not be sufficient to finance the conduct of its business.”
2. No “outside investor” would have made the advances without “adequate security,” which the corporation was unable to provide.
3. Stockholders agreed to make advances proportionately to their stock holdings.
4. Advances were made without “normal creditor safeguards.”
5. No efforts were made “to enforce the obligations.”
6. At the time of the advances, “it was not reasonable to expect that they would be repaid unless the business should prove to be successful.”
7. As a matter of “substantial economic reality,” the advances were placed “at the risk of the business.”

These findings are fairly typical of recent Tax Court opinions decided against taxpayers, and may be described as the current “buckshot” approach. Actually, this example is quite conservative; for the court has amassed a vast number of badges of intended equity which it generally uses to pin on a conglomeration of facts to support its debt-equity conclusion. Among these are:

—Permanent capital structure.
—Risk of the business.
—Acquisition of permanent assets.
—Commencement of new business.
—Expectation of repayment regardless of earnings or success.
—Normal creditor safeguards.
—Presence or absence of security.
—Outside investor standard.
—Use of formal debt instruments.
—Intention to assert rights or creditor.
—Intention or action to enforce.
—Pro rata advances.
—Practical subordination.

172 Gilbert v. Com'r, 248 F. 2d 399 (2d Cir. 1957). See note 139.
—Ratio.
—Substantial economic reality.
—Business purpose.
—Real or true intent.
—Substance v. form.
—Sham.

The difficulty with the Tax Court opinions is their complete lack of consistency in applying these standards. Sometimes one or more will be touted as highly significant in indicating “equity.” At other times, these same features may be minimized and “true debt” found through the underlying intent of the parties. In other words, a particular standard is held forth as important or unimportant—depending upon the result the Court desires to reach.

Recent Tax Court Opinions.

A glance at recent Tax Court opinions quickly displays inconsistencies.

“Equity,” for example, was held to be intended in the following:

320:1 ($191,870:$ 600)—Aqualane Shores, Inc.;\(^{176}\)
50:1 ($600,000:$ 12,000)—Hoguet Real Estate Corp.;\(^{177}\)
8:1 ($900,000:$110,000)—J. A. Maurer, Inc.\(^{178}\)

In Aqualane, the ratio could be computed at 400:1 if outside debt were taken into account. In Hoguet, it might more accurately be stated at 600,000:0—the face amount of debentures being greatly in excess of the value of all property received for both capital and debt. In Maurer, loans initially guaranteed by the chief stockholder were treated as “in reality” advanced by him and only “nominally advanced” by banks.

“Debt,” in turn, was found in the following:

22,000:1 ($22,663,000:$ 1,000)—W. H. Truschel;\(^{179}\)
400:1 ($400,000:$ 1,050)—Leach Corporation;\(^{180}\)
50:1 ($500,000:$10,000)—J. I. Morgan, Inc.;\(^{181}\)
14:1 ($2,500,000:$177,840)—Harry F. Shannon.\(^{182}\)

In Truschel, the bonds were issued to former stockholders in buying out their interests.\(^{183}\) Leach, regarded by the court as a “close case,”

\(^{176}\) 30 TC No. 48 (May 29, 1958), on appeal to 5th Circuit.
\(^{177}\) 30 TC No. 55 (June 12, 1958) (“this is not a case of ‘thin capitalization,’ it is in fact a case of no capitalization”).
\(^{178}\) 30 TC No. 135 (Sept. 26, 1958), acq.
\(^{179}\) 29 TC 433 (1957), order amended 17 TCM 110 (1958).
\(^{180}\) 30 TC No. 54 (June 12, 1958), acq.
\(^{181}\) 30 TC No. 89 (July 9, 1958), acq.
\(^{183}\) Also see Estate of Ernest G. Howes, 30 TC No. 93 (July 11, 1958), involving same general transaction.
involved bonds issued pro rata to a group of stockholders holding 47.6% of the outstanding stock. Both *Morgan* and *Shannon* considered debt arising from sales of assets to the corporation. In the former, the 60% stockholder made the sale; while, in the latter, sales were made by a number of family members in proportion to their stockholdings.\textsuperscript{184}

Ratio, of course, is not the decisive factor in this type case. But it is a quick way of illustrating the comparative circumstances involved. More impressive than ratio in these recent Tax Court cases is the flagrant way the judges are able to discard previously emphasized tests to reach conclusions they have fixed upon.

In *Maurer*,\textsuperscript{185} holding that "advances constituted as a matter of practical reality (i.e., 'for tax purposes') an equity investment," the court disregarded the fact that advances were made in an arm's length transaction by a single stockholder holding 75% of the outstanding stock. However, the result was actually in favor of the corporate taxpayer, who was seeking to avoid an alleged deficiency for cancellation of indebtedness income. In *Shannon*,\textsuperscript{186} however, the court found debt despite pro rata holding of the obligations by stockholders in what looked like a carefully contrived tax plan. Here, the Commissioner was seeking to tax the "disposition" of an alleged installment obligation; and it was to his interest to find indebtedness. The court obliged by ruling that a bona fide sale had been intended, thereby creating the crucial debt instruments.\textsuperscript{187} *R. M. Gunn*,\textsuperscript{188} a "pure" ratio case, was not considered controlling.

In *Leach*,\textsuperscript{189} advances were made by minority stockholders in proportion to their stock holdings to finance the purchase of operating assets, the majority was a promoter group which had invested only a nominal amount; and the case might properly be viewed as another instance of pro rata financing by stockholders for tax minimization purposes. However, the lending was done by an outside English group; and you sense the conviction of the court that this was a legitimate business transaction, despite tax motivations. For this reason, the court overrode high ratio, proportionality and purchase of fixed assets. It did not regard the funds as being placed at the "risk of the business;" instead, it believed it was "their intention that the alleged loans be repaid in any event regardless of the fortunes of the enterprise."

\textsuperscript{184} Harry F. Shannon, 29 TC 702 (1958), overrode taxpayer's contention that equity had been created.
\textsuperscript{185} 30 TC No. 135 (Sept. 26, 1958), *acq*.
\textsuperscript{186} 29 TC 702 (1958).
\textsuperscript{187} See *INT. REV. CODE OF 1954*, §453 (d).
\textsuperscript{188} 25 TC 424 (1955), *aff'd per curiam*, 244 F. 2d 408 (10th Cir. 1957). See note 56.
\textsuperscript{189} 30 TC No. 54 (June 12, 1958), *acq*. 

Finally, in Morgan, the court ruled debt was intended in the face of high ratio, purchase of capital assets, and waiver of collection of payment. Gooding was feebly distinguished, but the key to the case appears to lie in the court's statement that it was convinced that "the transaction was not motivated by tax considerations."

Business Purpose and the Viscera.

Reconciliation of the Tax Court cases is nigh impossible. Reading these conflicting opinions, one gets the impression—as Randolph Paul observed in another context—that there has been "a great deal of churning of the void to make very little cheese."

The only thread running through these cases is the Tax Court's conception of business necessity or business purpose—nontax motivation at the corporate or stockholder level. Even though tax avoidance is present, as in Leach Corp, the court seems loath to condemn debt instruments when it appears their creation resulted from some legitimate business necessity or desire. Thus, thin incorporation is not invoked against publicly-owned corporations because of the usual lack of relationship between debt and stock ownership, and probably because of the belief that the means of financing is necessary to attract outside investment. Leach Corp. illustrates this, for the basic financing was provided by an English group which resold the debt-equity “package” to investment trust clients. Again, in Morgan, the need to provide proprietary interests for key employees seemed sufficient justification for incorporating a venture and using corporate indebtedness, where this reduced the value of the capital stock and permitted former employees to acquire a larger percentage interest at a small cost.

Tax Court as Censor.

In light of the foregoing, the Tax Court is now emerging as a censor, to determine the legitimacy of the purposes for creating debt instruments. It examines all surrounding circumstances, refuses to be bound by prior precedents, relies apparently on an internal reaction to the “propriety” of the transaction, and then assembles a combina-

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190 30 TC No. 89 (July 9, 1958), acq.
191 Gooding Amusement Co., 23 TC 408 (1954), aff’d, 236 F. 2d 159 (6th Cir. 1956). See note 84.
192 See PAUL, STUDIES IN FEDERAL TAXATION 18 (3rd Series 1940).
193 30 TC No. 54 (June 12, 1958), acq.
195 30 TC No. 89 (July 9, 1958), acq.
196 Compare aberrations of the Tax Court, disregarding the corporate entity, in cases like: Oreste Casale, 26 TC 1020 (1956), rev’d, 247 F. 2d 440 (2d Cir. 1957); Henry E. Prunier, 28 TC 19 (1957), rev’d, 248 F. 2d 818 (1st Cir. 1957); Joseph R. Holsey, 28 TC 962 (1957), rev’d, 58-2 USTC §9816 (Sept. 3, 1958). Also, see Thomas F. Doran, 15 TCM 629 (1956), rev’d, 246 F. 2d 934 (9th Cir. 1957).
tion of previously enunciated standards to sustain its conclusion. Such a visceral approach would be more defensible under a general statute providing for nonrecognition of tax avoidance plans. But it hardly seems appropriate in interpreting a simple and specific provision of a highly detailed Code. Courts "are not at liberty to construe language so plain as to need no construction, or to refer to Committee reports where there can be no doubt of the meaning of the words used."

**Congressional Intent.**

Congress does not seem to have made such a broad grant of power to the courts in this area. As was said in *John Kelly Co.* "These cases now under consideration deal with well understood words as used in the tax statutes—"interest" and 'dividends.' They need no further definition." In brief "dividends" and "interest," "stocks" and "bonds," "debentures" or "notes" are all "correlative and clearly identifiable conceptions in their simpler and more traditional exemplifications." They do not involve the scope and indefiniteness of a more comprehensive concept such as "reorganization." When drafted in unambiguous terms, a clear debt instrument would therefore seem to leave little room for judicial play in interpreting the present statute. Accordingly, if the parties "really and truly" intend to create

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207 Compare general tax-avoidance provisions contained in the Code: *e.g.*, INT. REV. CODE OF 1954, §§269 ("the principal purpose . . . avoidance") ; 341 ("with a view to") ; 357 ("the principal purpose") ; 367 ("one of its principal purposes") ; 432 ("to prevent evasion") ; 532 (a) ("for the purpose of avoiding the income tax") ; 1551 ("a major purpose")

208 The debt-equity issue usually arises in the following context:

1. Is it "interest" on "indebtedness" under INT. REV. CODE OF 1954, §163?
2. Is it a worthless "debt" under INT. REV. CODE OF 1954, §166?
3. Is it a distribution with respect to "stock" under INT. REV. CODE OF 1954, §301?
4. Is it a redemption of "stock" under INT. REV. CODE OF 1954, §302?
5. Is it an exchange for "stock or securities" or "other property" under INT. REV. CODE OF 1954, §351?


200 Id. See note 28.

201 Id. at 535. The term "interest" has been given everyday meanings: "the amount which one has contracted to pay for the use of borrowed money," Old Colony R. Co. v. Com'r, 284 U.S. 552, 560 (1932); and "compensation for the use or forebearance of money." Deputy v. du Pont, 308 U.S. 488, 498 (1940).


a debtor-creditor relationship—their intention being determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions"—the relationship should be recognized regardless of its wisdom or tax-saving possibilities.

The development of the thin incorporation doctrine has been referred to as "an exercise in administrative invention and judicial legislation which has generated intolerable confusion." For the five years 1954 through 1958, debt-equity issues have arisen in approximately 100 cases. Inequities have occurred from conflicting treatment of taxpayers in comparable positions. The resulting uncertainty over this very common problem—due to the inability of the judiciary and administrators to evolve a reasonable solution—justifies corrective legislation.

POSSIBLE LEGISLATIVE SOLUTIONS

Prior Legislation.

Congress has been alerted to the tax advantages flowing from corporate indebtedness. And there have been occasions in the past when it adopted specific legislation limiting possible abuses:

—In the 1909 excise tax on corporate net income, indebtedness was recognized only to the extent of paid-up capital stock. Interest on indebtedness exceeding this was not deductible.

—In the 1913 income tax on corporate net income, indebtedness was recognized up to "one-half of the sum of its interest bearing indebtedness and its paid-up capital stock." This was a 1:1 ratio, with an interest deduction being disallowed on any excess.

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RABKIN & JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION §35.08(2) (1954).

Of approximately 100 debt-equity cases from 1954-1958, the Commissioner has won about 66 2/3%—a ratio of 2:1.


Revenue Act of 1909 §38 (2d).

Revenue Act of 1913 §11(G) (b).
In the 1916 Revenue Act, the indebtedness recognized was increased to an amount equal to the total of paid-up capital plus one-half of the interest bearing indebtedness.\textsuperscript{210} Interest on any excess debt was again not deductible.

In 1919, finally, with the World War I excess profits tax, all restrictions were removed. As borrowed capital was not included in computing invested capital, it seemed "only fair to allow as a deduction in computing net income the whole amount of the interest paid during the year."\textsuperscript{211}

Since then, Congress has been silent on the question of limiting the tax consequences which result from use of debt obligations. And it would seem that, until Congress speaks again, full tax recognition must be given under the present statute to straightforward debt instruments intended to create debtor-creditor relations.

\textit{1954 A.L.I. Draft.}

In 1954, the American Law Institute attempted to provide some certainty in the debt-equity area by establishing a statutory definition of debt. At that time, it took the position that there should not be "any limitation upon the amount of indebtedness held pro rata by shareholders."\textsuperscript{213} Added to this was the statement that "a limitation of this sort is not a part of present law."

The approach taken was to provide six indicia of debt: if they were present in a corporate instrument no further inquiry was to be made. However, the proposed statutory definition was not to be exclusive. For, absent one or more of these criteria, a taxpayer would still be free in a given case to prove that bona fide debt was involved.

Under Section X500(g) of the ALI 1954 Draft, the characteristics of debt were stated as follows:\textsuperscript{214}

1. Unconditional obligation to pay a sum certain in money;
2. Maturity on or before fixed date;
3. Issuance for adequate consideration or as a dividend;
4. No subordination to trade creditors generally;

\textsuperscript{210} Revenue Act of 1916 §12(a) (3d). Also, see Revenue Act of 1917 §1207(1).
\textsuperscript{211} Revenue Act of 1918 §234(a) (2). See H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918), 1939-1 CUM. BULL. (Part 2) 94.
\textsuperscript{212} Compare proposed definition of "securities" in Section 312(c) of the House version of H.R. 8300. See H.R. Rep. No. 1337, 83rd Cong. 2d Sess. A99 (1954). This was omitted from the Senate bill. See S. Rep. No. 1635, 83rd Cong. 2d Sess. 42 (1954).
\textsuperscript{214} II American Law Institute Statute 2-3.
(5) No voting rights, except on default; and
(6) Interest payments, if any, not to be dependent on earnings and
to be paid by maturity date of principal amount.


In 1956, the Tax Section of the American Bar Association went
one step further than the ALI by recommending a 10:1 ratio.\(^{215}\)

The ABA generally followed the ALI in recommending non-
exclusive rules for the treatment of corporate debt obligations held
by stockholders. The ABA definition of “debt,” proposed as Code
Section 317(c), was similar to the ALI definition; but gave complete
statutory protection to indebtedness only up to the 10:1 mark. This was
accomplished by providing that if “the ratio of the principal amount
of all creditor obligations . . . held in the aggregate by its stockholders
exceeds by more than ten to one the book value of the stock held in the
aggregate by such stockholders immediately after such creditor obliga-
tions are issued this subsection shall not apply to the amount of such
creditor obligations which exceed such ratio.”

Because of the “variety of rationalizations” used by the courts,
the Tax Section believed that “some area of certainty should be es-
tablished by legislation within which corporations might be organized
and financed with assurance that what investors desire to be treated
as debt will be so treated.”\(^{216}\)


The Mills Subcommittee Advisory Group on Subchapter C has
noted\(^{217}\) the uncertainty illustrated by the Gilbert case.\(^{218}\) To ease the
problem, both its 1957 and 1958 reports propose a new code selection
317(c), establishing a non-exclusive definition of indebtedness along
the lines of the ALI proposal. However, like the ABA, the Advisory
Group was disturbed by possible excessive debt structures and there-
fore suggested a 5:1 ratio limitation.

Under the Advisory Group proposal, “indebtedness” is defined to
“include in all events (but shall not be limited to)”:\(^{219}\)

1. Unconditional obligation to pay a sum certain in money;
2. Maturity on demand, or on or before a fixed and not unreason-
ably distant date;

\(^{215}\) See American Bar Association Section of Taxation, 1956 Program and Committee Reports to be Presented at the Seventeenth Annual Meeting 36-38 (1956).

\(^{216}\) Id. at 37.


\(^{218}\) 248 F. 2d 399 (2d Cir. 1957). See note 139.

(3) Issuance for adequate consideration or as a distribution to stockholders;
(4) No subordination to trade creditors;
(5) No voting rights;
(6) Interest, if any, not to be excessive, not to be dependent on earnings, and unconditionally due no later than maturity date of principal amount;
(7) Issuance under circumstances not negating "any reasonable expectation of payment"; and
(8) If "initially held or guaranteed by a shareholder . . . immediately after the obligation is created the principal amount of all obligations of the corporation held or guaranteed by its shareholders does not exceed by more than five-to-one the fair value of the outstanding stock of the corporation or the total of the capital and surplus paid-in with respect thereto, whichever is greater."

In making this recommendation, the Advisory Group "believed that such a provision would be of special benefit to small incorporated businesses and the owners thereof; for, unlike publicly held corporations, small closely held corporate businesses must often look to their stockholders as the only source of borrowed money."

1958 TECHNICAL AMENDMENTS ACT.

Thin incorporation problems have been alleviated, but certainly not dissipated, by the Technical Amendments and Small Business Tax Revision Acts of 1958. Incentives for thinning are lessened by Subchapter S, permitting a corporation to elect not to be taxed, and by Code Section 1244, allowing a limited ordinary deduction for losses on small business common stock. Yet, despite the applicability of these provisions, many situations remain where the parties will still prefer using corporate indebtedness.

Subchapter S Election.

Under the Subchapter S election, stockholders are taxed on actual dividend distributions plus their pro rata share of the corporation's "undistributed taxable income." Corporate earnings are thereby no longer subject to so-called double taxation, thus eliminating the need of the interest deduction previously used to accomplish this same purpose. Furthermore, as an electing corporation will generally not have current earnings and profits, it may return a stockholder's in-

\[\textit{footnotes}\]

222\textit{Int. Rev. Code of 1954, §1373.}
223\textit{See note 9.}
vestment in his stock without threat of dividend consequences—unless the corporation has an earnings and profits history antedating its election. This should render obsolete the previous practice of using debt as a vehicle for returning investment free of the hazard of Code Section 302(d). Finally, as ordinary losses of an electing corporation are proportionately treated as business losses of each stockholder—deductible to the extent of his basis for stock and advancements—no inducement remains to try to fit an investment into a bad debt deduction pattern.

**Estate Planning Problem.**

But stockholders of an electing small business corporation may, nevertheless, continue to demand debt obligations. For one thing, a corporation may have only one class of stock if it is to be eligible for the election. As preferred stock will not be available for family planning, stockholders may insist upon fixed income, nonvoting securities for gifts to wife and children.

**Danger of Distribution and Lend-Back.**

Furthermore, particularly for old corporations with pre-election accumulated earnings, there will be concern over leaving current profits in the corporation which may become "frozen in" if the election is lost or if stock is transferred. Some electing corporations are finding it advantageous to distribute all profits of the year, to avoid possible distribution problems in the future, and then "lend-back" to the corporation all or part of these funds. As can be seen, this could soon lead to the specter of the thin incorporation threat.

**Capital Gain Possibilities.**

Debt may also provide new capital gain possibilities for stockholders of Subchapter S corporations. If early losses of the venture absorb a stockholder's basis for his stock and all or part of his basis for corporate debt, the indebtedness may later be sold or retired with capital gain results. Such a sale would leave his stock ownership undisturbed; and the retirement would be free of the "essentially equivalent to a dividend" threat—if the indebtedness is valid.

**Dangers Flowing from Disqualification.**

Thin incorporation therefore remains a problem, albeit a limited one, for electing corporations. However, new and even more serious consequences may flow from an adverse holding. If purported debt is found really intended as equity, might it not follow that the corporation

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225 See note 3.
227 See notes 5-7.
229 See note 4.
is disqualified under the "one class of stock" requirement? While arguments could be advanced that this quasi-equity should be considered a contribution to capital—added to the common stock investment, it is not inconceivable the Treasury would argue that it is to be regarded as a second class of stock, in the nature of preferred stock. Such a determination would immediately disqualify the election for the year in question and for all years during which the "indebtedness" was outstanding.

**Losses on Small Business Stock.**

Section 1244 should prove a counterforce to the use of debt in financing small corporations. This recent amendment generally allows an individual an ordinary deduction for losses on the sale, exchange or worthlessness of common stock, referred to as "section 1244 stock." Similar to the pattern under Code Section 1231, gains on such stock still qualify for capital gain treatment. The new deduction may not exceed $25,000 in any one year, or $50,000 if husband and wife file a joint return: any excess loss must run the gamut of the capital loss limitation.

Under this liberal provision, a stockholder may attain much more favorable tax treatment from worthless stock than from worthless loans. Consequently, where a risky venture is involved, investors may now favor common stock in place of debt securities. As noted above, if the Subchapter S election were in force, current losses would be directly deductible to the stockholder up to his total basis for stock and for loans to the corporation. Code Section 1244 offers further advantages. Prior to the absorption of the stock's basis under Subchapter S, Section 1244 allows an ordinary loss deduction by sale or exchange of the stock.

Code Section 1244 provides relief only for the common stock of a domestic corporation, and only if its total equity capital is not over $1,000,000 and the total capital paid in after June 30, 1958, is not over $500,000. Hence, though a corporation has outstanding preferred stock which automatically disqualifies it under Subchapter S, its common stockholders may be eligible for Section 1244 benefits. On the other hand, if the size of a corporation's capital bars Section 1244 to its stockholders, its one class of stock may still leave it eligible under Subchapter S.

In brief, the use of common stock may bring tax benefits either under Subchapter S or Section 1244; or, if the corporation can meet

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232 Five years' delay may be encountered before being eligible for a new election. *Int. Rev. Code of 1954*, §1372(f).
the different statutory standards, may result in advantages under both. Before following old patterns, therefore, a corporate investor would do well to consider the availability of this new legislation.

SOME PRACTICAL SUGGESTIONS

Practitioners must continue to wend their way through the circuitous course plotted by conflicting thin incorporation decisions. Giving advice on this issue is extremely difficult, often unsatisfactory both to attorney as well as client.

Until the current confusion is ended by the courts—or until new legislation is adopted—no quick or positive solution is possible. The following suggestions, therefore, are intended only as a general guide. They represent a composite of many judicial theories, often conflicting, pronounced in this field. No attempt is made in this summary to question the validity of these standards, nor is it suggested that they are applicable or attainable in all cases. Rather, they are meant to mark the weak spots hammered upon by judges, and to suggest safeguards against future attacks by the Commissioner.

1. Material amount of equity: “Material amounts” of capital should be invested in stock. This is a qualitative test, obviously varying among different industries and among businesses within a single industry. Ideally, the equity investment should be sufficient to acquire the “core assets,” those essential for the basic operation of the business. Explore the economic feasibility of operating the business on a limited scale: for example, consider the possibility of leasing arrangements. By demonstrating that the equity was adequate to support a stripped-down version of the operation, the taxpayer will find his position strengthened on the materiality issue.\footnote{Cf. J. I. Morgan, Inc., 30 TC No. 89 (July 9, 1958), _acq._ See note 181.}

2. Realistic debt structure: The debt structure should be planned carefully and realistically. Project the future earnings and future borrowing capacity; examine the probable cash-flow of the business. Maturities of indebtedness should be geared to these financial considerations; interest obligations should not be in excess of estimated net earnings available. If possible, repayment should be provided from the operation itself rather than through refinancing. Most important is to avoid creating a debt structure which cannot be discharged in the normal course of business and which may lead to defaults.

3. Straightforward indebtedness: The instruments should be clear and unambiguous: an unconditional obligation to pay a sum certain at a reasonably near future date. Interest should be payable at the going rate. It should not be dependent on earnings or someone’s discretion. Subordinaiton should be avoided; and there should be no voting rights. Negotiable paper is clearly preferable.
4. **Collateral:** To the extent possible, the indebtedness should be secured. The presence of a mortgage or other collateral is strong evidence of the bona fides of the arrangement.

5. **Corporate formalities:** Corporate records should be carefully kept, reflecting the intention to create a debtor-creditor relationship. In addition to issuing properly drawn negotiable instruments, corporations should consistently record the transactions in their minutes and financial accounts.\(^2\)

6. **Identify consideration:** When assets are transferred for both equity and debt, care should be taken to identify the consideration given for each: show the assets transferred for capital stock; and, as a separate transaction, show those transferred for instruments of indebtedness. Use fair valuations, backed by appraisals, in fixing the terms of the exchanges. This helps defeat a charge of indefiniteness of intent; it evidences the phase of the transaction meant to create a debtor-creditor relation.

7. **Avoid pro rata lending:** Pro rata loans, in proportion to stockholdings, are often regarded as indicative of an intention to make capital contributions. Family lending is sometimes viewed as an entirety and compared to the group’s total stockholdings. For these reasons, loans disproportionate to stockholdings should be negotiated. Borrowing from non-stockholders, for example, usually creates little problem. Similarly, when a minority stockholder finances the bulk of the later advances, debt is more likely to be found. Even when the majority stockholder makes most of the loans, the absence of proportionality is significant. In brief, try to “break the proportions” as much as possible.\(^3\)

8. **Borrow in stages:** Funds should be borrowed only as and to the extent needed. Lump sum lending on incorporation is more indicative of capital contribution than emergency loans made to satisfy particular needs.\(^4\)

9. **Different types of indebtedness:** As different loans are made, consider using various forms of debt instruments: bonds, debentures, notes. This will provide a basis for finding that at least one earmarked portion of the transaction was intended as bona fide debt. Courts have usually followed an all-or-none approach in testing indebtedness. By distinguishing the various lending phases, a taxpayer will create a more favorable climate for partial relief.

\(^{233a}\) *Cf.* U.S. Asiatic Co., 30 TC No. 144 (Sept. 30, 1958): ratio 71:1 ($71,000: $1,000); no corporate formalities, no note, no provision for interest; “arbitrary allocation” of total sum advanced.

\(^{234}\) *Compare* Leach Corporation, 30 TC No. 54 (June 12, 1958), *acq.*, with Hoguet Real Estate Corp., 30 TC No. 55 (June 12, 1958). See notes 180 and 177.

\(^{235}\) Compare the creditors' rights cases of International Tel. & Tel. Corp. v. Holton, 247 F. 2d 178 (4th Cir. 1957); and Arnold v. Phillips, 117 F. 2d 497 (5th Cir. 1941), *cert. den.*, 313 U.S. 583 (1941).
10. **Trust as lender:** Consider having stockholders create trusts for family members, transfer funds to the trustee, and induce the trustee to make loans to the corporation. As an alternative, the stockholder might make the loan directly to the corporation, with instruments of indebtedness being endorsed over or issued directly to the trustee. The presence of a trustee has been noted favorably in this type case,\(^{236}\) as well as in other areas of the tax law.\(^{237}\) Recognition is given to the legal obligations and liabilities which result from the fiduciary relation, and courts tend to uphold trustee transactions as bona fide.

11. **Guaranteed loans:** Bank loans guaranteed by stockholders have been suggested as a solution for the thin incorporation problem. A variation is to have stockholders lend collateral to the corporation, instead of endorsing its paper. While these arrangements present additional hurdles to the Service, they are by no means insurmountable. There are indications that the courts will look through the various steps and treat the loans as made, in effect, by the stockholders themselves.\(^{238}\) However, so long as the parties recognize the risks involved, there seems little to be lost in attempting the guarantee or collateral plan. Of course, most desirable would be to have the bank make advancements on the credit of the corporation only.

12. **Business purpose:** Of prime importance is the recording of the nontax reasons for issuing debt. Whether they be motivations of stockholder or corporation, they are regarded as crucial by the courts. Correspondence, minutes and other corporate documents should be at hand to reflect the contemporaneous thoughts of the parties in deciding to employ debt instruments.

13. **Reasonable expectations of repayment:** Recognition must also be given to the significance of the lender’s reasonable expectations of repayment. His confidence in the success of the venture, scrutiny of the projected earnings, care in negotiating the terms of the loan and general conduct, would all be balanced against the soundness of the proposed undertaking, the risks involved and reasonableness of the capital structure. Evidence on this should be carefully preserved.

14. **Acting like creditor:** Related to his expectations of repayment is the lender’s subsequent action in enforcing the debt obligations. To the extent possible, interest and principal payments should be made on time. This again suggests the importance of planning a realistic, eco-

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\(^{236}\) Cf. Miller’s Estate v. Com’r, 239 F. 2d 729, 732-33 (9th Cir. 1956). See note 115.

\(^{237}\) Compare White v. Fitzpatrick, 193 F. 2d 398 (2d Cir. 1951), cert. den., 343 U.S. 928 (1952), with Wofford v. Com’r, 207 F. 2d 749 (5th Cir. 1953), Brown v. Com’r, 180 F. 2d 926 (3rd Cir. 1950), cert. den., 340 U.S. 814 (1950), and Skemp v. Com’r, 168 F. 2d 598 (7th Cir. 1948). See Cohen, Transfers and Leasebacks to Trusts: Tax Planning Considerations, 43 Va. L. Rev. 31 (1957).

nomically sound pay-out program. If delays are encountered, written demands should be made for payment. In extreme situations, consideration should be given to taking some form of action to collect unpaid interest or principal. This would have added weight when advances did not bear a proportionate relationship to stockholdings.

15. Ratio: Finally, mention must be made of ratio—the caloric count of a thin incorporation. This is perhaps the most difficult suggestion to make because of its varying treatment in the courts. Technically, under a close reading of the dictum in John Kelley Co., the issue should not be relevant if "material amounts of capital" are invested. And we can recall how, in Gooding Amusement Co., the modest ratio of 1:1 was discarded as of no help to the taxpayer in view of other objective manifestations of his intent. Yet, we do have the reassuring suggestion of Judge Waterman in Gilbert that a ratio of 2.19:1 renders that particular standard of "no value" in testing the validity of alleged debt.

Perhaps all that may be added is the importance at present of exercising restraint. Under a 1:1 ratio, an investor may recapture 50% of his investment if his advances are treated as debt. At 2:1, he recaptures 66 2/3%, with the corporation getting interest deductions on that percentage of the financing. Ratios, therefore, in the 1:1 to 2:1 range give sizable tax benefits and, at the same time, are regarded as not creating inferences adverse to the stockholder. While much higher ratios have been upheld—particularly where unincorporated going concerns are transferred to new corporations—the area of tax danger expands in direct proportion to the increase in ratio over 2:1. Legislation, it is hoped, will clarify this particular issue—under the Mills Subcommittee Advisory Group proposal, 5:1 being the cut-off point. But until Congress speaks, tax advisers will have to caution clients of the enlarged risks in ratios of 3:1 or more.

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240 23 TC 408 (1954), aff'd, 236 F. 2d 159 (6th Cir. 1956). See note 84.
241 248 F. 2d 399, 410 (2d Cir. 1957). See note 139.
243 See notes 68-82.